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Power and Influence in the US Investment Banking Industry – a Case Study of Lehman Brothers

Paul Mazzola
University of Wollongong

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2018

**Power and Influence
in the US Investment Banking Industry –
a Case Study of Lehman Brothers**

Paul Mazzola

University of Wollongong

**This Thesis is submitted in fulfilment of the requirements for the award of
the degree**

DOCTOR OF PHILISOPHY

From the

UNIVERSITY OF WOLLONGONG

By

Paul Mazzola B.Com., M.App.Fin.

School of Accounting Economics and Finance

Certification

I, Paul Mazzola, declare that this thesis, submitted in partial fulfilment of the requirements for the award of Doctor of Philosophy, in the School of Accounting, Economics and Finance at the University of Wollongong, is wholly my own work unless otherwise referenced or acknowledged. This thesis has not been submitted for qualifications at any other academic institution.

Paul Mazzola

February 2018

Dedication

I wish to dedicate this thesis to my children, Isabella, Gemma and Giacomo who have managed to endure this journey by my side with patience, good humour and love.

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“There are never wanting some persons of violent and undertaking natures, who, for they may have power and business, will take it at any cost”

(Bacon 1844, p. 388).

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Table of Abbreviations

Abbreviation	Meaning
AcSEC	Accounting Standards Executive Committee
AIG	American International Group Inc.
AMPTA	Alternative Mortgage Transactions Parity Act 1982
ARM	Adjustable Rate Mortgages
AUM	Assets Under Management
BoA	Bank of America
BRIC	Brazil, Russia, India and China
BSAM	Bear Stearns Asset Management
CAGR	Compound Annual Growth Rate
CAO	Chief Administrative Officer
CCR	Compensation Committee Report
CDO	Collateralised Debt Obligation
CDS	Credit Default Swaps
CEO	Chief Executive Officer
CFMA	The Commodity Futures Modernization Act 2000
CFO	Chief Financial Officer
CFRP	Centre for Responsive Politics
CFTC	Commodity Futures Trading Division
CNC	Covenants not to compete
Comp Ratio	Compensation Ratio

COO	Chief Operating Officer
CRA	Credit Rating Agency
CRA Expansion	CRA Expansion Act 1999
CRA Act	The Community Reinvestment Act 1977
CRO	Chief Risk Officer
CSA	Confederate States of America
CSE	Consolidated Supervised Entity
CUSIP	Committee on Uniform Security Identification Procedures
CWT	Cadwalader, Wickersham & Taft
E3	CDO Evaluator Version 3.0
Fannie Mae	Federal National Mortgage Association
FAS 125	Statement of Financial Accounting Standard Number 125
FAS 140	Statement of Financial Accounting Standard Number 140
FAS 157	Statement of Financial Accounting Standards Number 157
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
Fed Funds Rate	Federal Reserve Funds Rate
FFIEC	Federal Financial Institution Examination Council
FHFA	Federal Housing Finance Agency
FID	Fixed Income Division
FINRA	Financial Industry Regulatory Authority
Freddie Mac	Federal Home Loan Mortgage Corporation
FSR	Financial Services Roundtable
GAAP	Generally Accepted Accounting Principles

GBP	British Pounds
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GFS	Gouvernement Financial Statistics
GLBA	The Gramm Leach Bliley Act
GNI	Gross National Income
GSA	The Glass-Steagall Act
GSE	Government Sponsored Enterprise
High-Grade	High-Grade Structured Credit Strategies Fund
HY LBO	High Yield Leverage Buyouts
IASC	International Accounting Standards Committee
IFRIC	International Financial Reporting Interpretations Committee
IPO	Initial Public Offering
JP Morgan	John Pierpont Morgan
KPI	Key Performance Indicators
LB or LBHI	Lehman Brothers Holdings Inc.
LBi or LBIE	Lehman Brothers International (Europe)
M&A's	Mergers & Acquisitions
MBS	Mortgage Backed Securities
MSCI	Morgan Stanley Capital International
NBFI	Non Bank Financial Institution
NMI	Non-Majoritarian Institutions
NPAT	Net Profit After Tax
NPBT	Net Profit Before Tax

NR	Net Revenue
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
OTC	Over the Counter
PCAOB	Public Company Accounting Oversight Board
POGO	Project on Government Oversight
PSA	Public Securities Association
QSPE	Qualifying Special Purpose Entity
RCA	Radio Corporation of America
Regulation AC	Regulation Analyst Certification
REIT	Real Estate Investment Trust
Repo 105	Repurchase Agreements 105
Repos	Repurchase Agreements
Revolution	American Revolutionary War in 1775
RMBS	Residential Mortgage Backed Securities
ROA	Return on Assets
ROE	Return on Equity
RSU	Restricted Stock Unit awards
SEC	Securities Exchange Commission
Short Termism	Maximisation of Short Term Profits
SIA	Securities Industry Association
SIFMA	Securities Industry and Financial Markets Association
SOX	Sarbanes-Oxley Act of 2002

S&P	Standard & Poor's
SPV	Special Purpose Vehicle
SRO	Self-Regulatory Organization
TARP	Troubled Asset Relief Program
TBMA	The Bond Market Association
TC&I	Tennessee Coal, Iron & Railroad Company
The Assembly	The Pennsylvania Assembly
Union	Northern States of America
US	The United States of America
USD	United States Dollars
VaR	Value at Risk
WW1	World War 1
WW2	World War 2

Abstract

The Global Financial Crisis caused upheaval to the world economy, triggered many corporate failures, and inflicted significant social distress with long lasting ramifications. This thesis applies DiMaggio and Powell's (1983) New Institutional Theory and Clegg's (1989) Theory of Power to analyse contributing factors to the collapse of the investment bank Lehman Brothers. This is achieved by employing a case study approach which examines reasons for the failure. It is of interest because Lehman Brothers was the only major US investment bank allowed to fail by regulators at this time. Isomorphic influences and interplays of power associated with the US investment banking industry are contextualised in the study.

This thesis finds contributing factors to Lehman Brothers' collapse included the risks of a 'light touch' approach to investment banking regulation; deficiencies in the capital adequacy rules; and, consequences of a lack of oversight over innovative practices. It is found that regulators were subjected to regulatory capture by the investment banking industry, and deviated from their role as stewards of the public interest. Similarly, the thesis finds risks to asset markets were heightened by a prolonged neo-liberal approach to economic policy. The investment banking industry's influence over politicians and regulators through lobbying, political contributions, and the use of the 'revolving door' was a way of influencing legislative and economic policy outcomes to their benefit.

Further, the business and political connections of the US investment banking industry which, when combined with specialised knowhow and an ability to innovate, generated powerful commercial advantage. The influence exerted by the investment banking industry extended to credit rating agencies and accounting standard setters, groups which could impact the

potential profitability of the industry. The investment banking industry was able to encourage the issuing of inflated credit ratings for their securitisation vehicles and clients. Additionally, the industry was instrumental in the design of an accounting standard applying to repurchase agreements which was open to ambiguous interpretation, allowing Lehman Brothers to conceal significant amounts of debt from stakeholders.

The Lehman Brothers case study revealed that unbridled power, especially when motivated by self-interest, generated a dysfunctional organisational culture. Individuals' behaviours were driven by a 'survive at all costs' mentality. This setting led to poor management decisions within a weak corporate governance system causing the firm's ultimate demise. It reveals the limitation of regulations to control behavior, and signals a need for regulators who routinely deal with firm and systemic risk to focus more attention towards corporate culture. The systemic risk was compounded by an institutional isomorphism which engendered common business models amongst the industry peer group. This resulted in similar financial structures typified by excessive leverage, which were tested during the global financial crisis and found to be inadequate, requiring urgent government intervention. The findings of this thesis could help prevent future costs to taxpayers, investors, and society.

Key words: GFC, investment banking, power, institutional theory, Repo 105, corporate governance, bank regulation.

CHAPTER 1 INTRODUCTION

The Global Financial Crisis (GFC) which peaked during 2008, significantly impacted the global financial system with dire consequences for the world economy. The resulting social effects touched many individuals and its impact has been long lasting. The GFC also triggered the failure of several large financial institutions including banks and investment banks, including Lehman Brothers Holdings Inc (LB), the subject of the case study in this thesis. The economic cost of the GFC has been difficult to estimate due to the far reaching nature of its impact. However, according to Porter (2014), based on a model developed by the Federal Reserve Bank of Dallas, it was noted that:

... The [US] economy would return to its previous path by 2023 and concluded that the total loss would amount to 40 per cent to 90 per cent of a year's worth of economic output. That's about \$US6 trillion to \$US14 trillion in today's money – or \$US19,000 to \$US45,000 per person (Porter 2014).

Using a broader measure, which takes into account the cost to the US government and the impact to US workers in general, the cost of the GFC approximated USD 180,000 per person in the US (Porter 2014). Therefore given the magnitude of the crisis, a study relating to the GFC is considered a worthwhile contribution to the literature at a time when the world is still suffering from its impacts. This thesis is motivated by a desire to better understand the causes of the GFC by examining the largest corporate failure in US history up to that time in 2008. Rather than limiting the analysis to economic or technical factors, the thesis peels back the layers of the causes of LB's failure to reveal a story involving human and organisational interactions within a socially constructed environment. There is a relative dearth of qualitative research on the investment banking industry which this thesis addresses. There are various contributing factors that led to the GFC which are either technical or qualitative in nature. This thesis analyses certain qualitative factors and explains an often ignored cause of the GFC which relates to organisations' cultural and persons' behavioural characteristics, which played a profound role in the years leading to its manifestation.

The primary contribution of this thesis is its use of two theoretical frameworks in explaining the downfall of LB and providing a rich insight into the investment banking industry and the role of the financial network in the lead up to the GFC. The application of the two theoretical frameworks is unique and was necessary as the use of a single theory would have been insufficient to explain both internal and external influences on LB's failure. This use of two theories uses a methodology assuming a non-realist ontological stance (Chua 1986, Hopwood 1987, Hines 1988), that sees the culture of investment banking as socially constructed and socially constructing. An historical approach and case study method is also

unique in the context of explaining a financial crisis. A case study offers two important opportunities: firstly it allows an analysis of practice; and secondly, it permits an evaluation of the theory.

The scope of this thesis is limited to an investigation of the failure of LB which was selected for the case study as it was the only US investment bank officially allowed to fail by entering bankruptcy. The case study extends to 15 September 2008, when LB declared bankruptcy. The commencement of the timeline is driven by the historical context which is detailed in CHAPTER 4 and CHAPTER 5 with the history of the investment banking industry and LB respectively. Therefore as the history of the US investment banking industry can be traced to the beginning of the American Revolutionary War in 1775 (the Revolution), this date has been used as the starting point.

A major limitation of this thesis is the timeline used with respect to the regulatory, commercial, social and political responses post-GFC. Similarly this study is conducted using the US as its subject field and a detailed discussion of the effective failure of other international investment banks and other economies is beyond the scope of this study and is recommended for future research. A final limitation of this study involves a significant reliance on secondary data from third parties such as journalists, and books authored by ex-employees who provide accounts of industry participants. The use of primary sources such as interviews of participants directly involved in the crisis would provide a deeper insight. The remainder of this chapter outlines the research question and the structure of the thesis.

1.1 Research Problem and Question

The causes of the GFC have been well canvassed in academic literature (Acemoglu 2009; Arup 2010; Brunnermeier 2009; Calomiris 2009a; Diamond & Rajan 2009; Fahlenbrach & Stulz 2011; Grant & Wilson 2012; Masood 2009; Mian et al. 2013; Obstfeld & Rogoff 2009; Paulson 2011; Pol 2012; Reinhart & Rogoff 2009; Sinclair 2010; Swedberg 2010; Tarr 2010; Taylor 2009a). The qualitative issues underlying the material decisions of the key players in positioning the economy, the profitability and financial structure of various organisations and the performance of the financial and other asset markets, however, are relatively under-researched. The research problem is therefore related to the relative lack of qualitative research relating to the causes of the GFC. In particular a search for the human and institutional influences which steered decision-making that led to the failure of financial markets and institutions and resultant economic and social turmoil. The case study approach featuring the largest corporate failure in the US at the time, which happened to be one of the largest US investment banks, sheds light on two forms of influence which contributed to the

calamity that followed. The research question posed by this study relates to the cultural aspects of the failure of LB and is articulated as follows:

To what extent did the cultural and behavioural influences through the context of an institutional framework and interplays of power within the investment banking industry contribute to the failure of LB?

The research question is answered through the lens of two theoretical frameworks. Firstly, DiMaggio and Powell's (1983) New Institutional Theory, which explains the institutional influences upon LB and a financial network consisting of the investment banking industry; other financial institutions (such as hedge funds, commercial banks, money market corporations and other financial institutions); the regulators; the government (including individual politicians); credit rating agencies (CRAs); and lobby groups representing the investment banking industry. Secondly, Clegg's (1989) Theory of Power is applied to reveal power relationships which enabled individuals to pursue organisational strategies consistent with fulfilling a personal agenda dominated by self-interest.

1.2 Plan of the Thesis

This introductory chapter outlines the purpose of the research as providing a rich insight into the culture and behavioural practices of LB and other participants in the investment banking industry in the US. CHAPTER 2 sets the economic, regulatory and political context over the time period immediately prior to the GFC. This includes a period of a neo-liberal political environment, a burgeoning economy and a 'light touch' to investment banking regulation. CHAPTER 3 outlines the theoretical lens used in this thesis which incorporates DiMaggio and Powell's (1983) New Institutional Theory, augmented by Clegg's (1989) Theory of Power. CHAPTER 3 also explains the methodology and method used in the research.

An understanding of the evolving culture and practice of the investment banking industry is assisted by the historical context described in CHAPTER 4. Profiles and behavioural characteristics of a sample of historical personalities are provided to describe practices within the investment banking industry which are found to persist up to the pre-GFC period. Certain historical events such as economic crises and trends such as the pressure to change corporate structures are also highlighted. These factors offer an understanding of the influences exerted on the evolution of the regulatory field and the opportunities and challenges confronting the investment banking industry throughout this period. Ultimately the historical influences help explain the industry's modern day *modus operandi*.

CHAPTER 5 follows with a history of LB, which tracks the development of the firm's culture through an account of the key individuals within the firm: from the three founding Lehman

brothers who established the business in 1850 to the Chief Executive Officer (CEO) Richard Fuld who presided over the firm during its demise in 2008. The chapter is divided between periods covering the pre-Fuld era and the post-Fuld era, in order to isolate specific cultural traits impacting the firm from the time Richard Fuld, LB's last Chairman and CEO, ascended to power. The pre-Fuld era represents LB's history prior to Richard Fuld's appointment as CEO and Chairman, whilst the post-Fuld era refers to the period following this appointment. Certain parallels are found to exist between behaviours and practices of the industry outlined in CHAPTER 4 and those found in LB. These parallels support the argument that common institutional influences affected various participants within LB throughout its history.

The last days of LB warrant a dedicated discussion in CHAPTER 6 given the important decisions made by senior management which directly led to the firm's downfall. An explanation of some of the important innovations and practices of the industry which were also adopted by LB, and the lack of transparency exhibited by the firm shed light on some of the cultural causes of the GFC. The decisions leading to the financial pressures on LB and which ultimately caused LB's liquidity crisis reveal the dysfunctional exertion of power by senior leadership within the firm. As the firm experienced a deterioration in performance, the regulators and public authorities, who were once subjected to powerful influences from industry, ultimately declined to rescue the firm.

CHAPTER 7 discusses the common business models and financial structures adopted by major US investment banks. As investment banks operate in a competitive and ambiguous environment where economic cycles, evolving technology and innovation are constant features and challenges, the mimetic pressures as explained by New Institutional Theory led divisional units of the peer group to undertake lines of business similar to each other. Further, the profitability benefits of the leverage effect were uniformly exploited by the major investment banks, despite the resultant dangers it conferred by way of an over-extended debt profile.

The value of connections developed by the investment banking community within the financial network is analysed in CHAPTER 8. A coercive influence as described by DiMaggio and Powell (1983) was exerted by the industry on these connections and led to a regulatory capture by the investment banking industry which influenced the regulatory process to produce an environment conducive to generating stronger financial performance. The same influence was exerted over the Credit Rating Agencies (CRAs) which published favourable and flawed credit ratings for customers of the investment banks and the firm sponsored securitisation vehicles. Further, the accounting standard setters who through a consultation process involving the investment banking industry issued an accounting standard – FAS 140 which allowed LB the flexibility to avoid the accounting of Repurchase Agreements (Repos) as debt, thereby 'window dressing' its financial statements by an understating of its leverage ratios. CHAPTER 9 further explains Repos in detail and analyses the power exerted by

LB's senior management in ensuring the accounting for this financial instrument achieved the desired effect of concealing significant levels of debt from its stakeholders.

CHAPTER 10 concludes by adding to the suggestion that Fuld exercised power for motives of self-interest. His exercise of power involved an influence over the firm's corporate governance system which was underpinned by his duality of role. This influence was exerted over board composition and involved supporting the appointment of ageing directors. These were mostly retired from their previous executive roles, and were lacking in the currency of modern investment banking innovations. The same directors lacked relevant expertise and experience, which was necessary to make informed decisions in their area of responsibility. Additionally there were attractive board compensation arrangements which enticed board members to remain on the board and perpetuate their longstanding friendly relationships with the Chairman and senior management. The board sub-committees met periodically and the frequency with which each sub-committee met signals the importance of the respective committees. For example the compensation committee met more frequently than the finance and risk committee implying a prioritisation of compensation over finance and risk matters. This combination of board attributes led to a less than optimal monitoring role and level of engagement from the board. A further insight into LB's corporate culture is shown by Fuld's relationship with employees, where he routinely exercised power, for example ensuring a lucrative employee compensation structure (refer section 10.5), to ensure the pursuit of his strategy of generating growth at all costs. This culture is highlighted by a rhetorical analysis of a corporate presentation and certain communications between senior executives of the firm. Finally, LB's stated commitment to ethical values is shown to diverge from the firm's practice. CHAPTER 11 summarises the thesis, presents a conclusion which reinforces the contribution of the thesis, and suggests areas for further research.

The following chapter establishes an appropriate background to the thesis by identifying the various causes of the GFC as covered by the literature. It also introduces two important themes which recur throughout the thesis, that is, the problem of insufficient capital regulation over the investment banking industry and the related problem of a neo-liberal approach to financial market legislation generally. The following chapter concludes with a justification for selecting LB as the subject of the case study used in the thesis. The case study method is further discussed in section 3.3.

CHAPTER 2 **BACKGROUND TO THE GFC**

This chapter provides a brief background to the GFC to set the economic, social and political context of the thesis. The chapter addresses the problem of insufficient capital regulation for the investment banking industry, the neo-liberal approach to financial market regulation and concludes with the selection of LB as the subject of the case study in this thesis.

The GFC was sparked in July 2007 with the failure of two highly leveraged hedge funds managed by Bear Stearns due to their investments in subprime mortgages¹. The crisis that ensued was termed the subprime crisis and effectively came to notice in early 2007 when lenders to the subprime borrower market began to experience a rising level of defaults. Housing construction companies were suffering from a deteriorating housing market. This affected banks' balance sheet structures, causing a liquidity crisis. The follow-on effects of this liquidity crisis universally affected the global banking system, culminating in devaluations of numerous asset classes, predominantly in the equity, debt and real-estate segments. LB failed on 15 September 2008 – the subject of the case study in this thesis.

Lucas highlighted the significance of the LB bankruptcy as a milestone in the crisis:

... until the Lehman failure the recession was pretty typical of the modest downturns of the post-war period. After Lehman collapsed and the potential for crisis had become a reality, the situation was completely altered (Lucas 2009, p. 67).

Similarly, Blinder noted:

...everything fell apart after Lehman went over the cliff, no financial institution seemed safe. So lending froze, and the economy sank like a stone. It was a colossal error, and many people said so at the time (Blinder 2009, p. 2).

¹ A subprime mortgage is a home loan made to borrowers who would under normal circumstances not qualify for a regular home loan. These loans are often associated with simple documentation (low-doc) and made available with no deposit requirements and/or little evidence of loan serviceability such as income tax returns. As a result these loans have a higher probability of default than a standard mortgage.

Henry Paulson, the prevailing US Treasury Secretary, confirmed the magnitude of the problem which affected the financial system and the market confidence upon which it relies:

We had a system crisis. Credit markets froze and banks substantially reduced interbank lending. Confidence was seriously compromised throughout our financial system. Our system was on the verge of collapse, a collapse that would have significantly worsened and prolonged the economic downturn that was already under way (Paulson 2008)

In addition to the depth of the crisis was the complexity associated with the various causes and their interrelationships. According to Brunnermeier (2009, p. 77) “The financial market turmoil in 2007 and 2008 has led to the most severe financial crisis since the Great Depression and threatens to have large repercussions on the real economy”. Literature to date has explored and surmised the GFC as having multiple contributory factors.(Acemoglu 2009; Arup 2010; Brunnermeier 2009; Calomiris 2009a; Diamond & Rajan 2009; Fahlenbrach & Stulz 2011; Grant & Wilson 2012; Masood 2009; Mian et al. 2013; Obstfeld & Rogoff 2009; Paulson 2011; Pol 2012; Reinhart & Rogoff 2009; Sinclair 2010; Swedberg 2010; Tarr 2010; Taylor 2009a). The Financial Crisis Inquiry Commission which was appointed by the US Congress in January 2011 summarised these contributory factors as follows:

widespread failures in financial regulation and supervision; dramatic failures of corporate governance and risk management at many systemically important financial institutions; a combination of excessive borrowing, risky investments and a lack of transparency; governments and regulators which were ill-prepared and inconsistent with each other in their approach to regulation; a systemic breakdown in accountability and ethics; the collapsing of mortgage lending standards and mortgage securitisation; over the counter (OTC) derivatives; and a failure of credit rating agencies (Financial Crisis Enquiry Commission 2011, pp. xv-xxviii).

Although there is continuing discussion about the causes of the GFC, we are offered some insights by the Leaders of the Group of 20², who concluded the following:

² The Group of Twenty (G20) is an assembly of the leaders of approximately 20 countries which meets regularly to discuss issues related to global economic governance. As at 2016 “The Group of 20 comprised 19 countries (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Republic of Korea, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, US and the European Union)” (Department of Foreign Affairs and Trade Australian Government 2016).

During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions (Leaders of The G20 2008).

These sentiments were not inconsistent with those of the prevailing chairman of the US Federal Reserve, Ben Bernanke³ who offered the following explanation:

The proximate cause of the crisis was the turn of the housing cycle in the US and the associated rise in delinquencies on subprime mortgages, which imposed substantial losses on many financial institutions and shook investor confidence in credit markets. (Bernanke 2009, p. 1).

Bernanke also attributed the crisis to aspects of the credit boom including:

... widespread declines in underwriting standards, breakdowns in lending oversight by investors and rating agencies, increased reliance on complex and opaque credit instruments that proved fragile under stress, and unusually low compensation for risk taking (Bernanke 2009, p. 1).

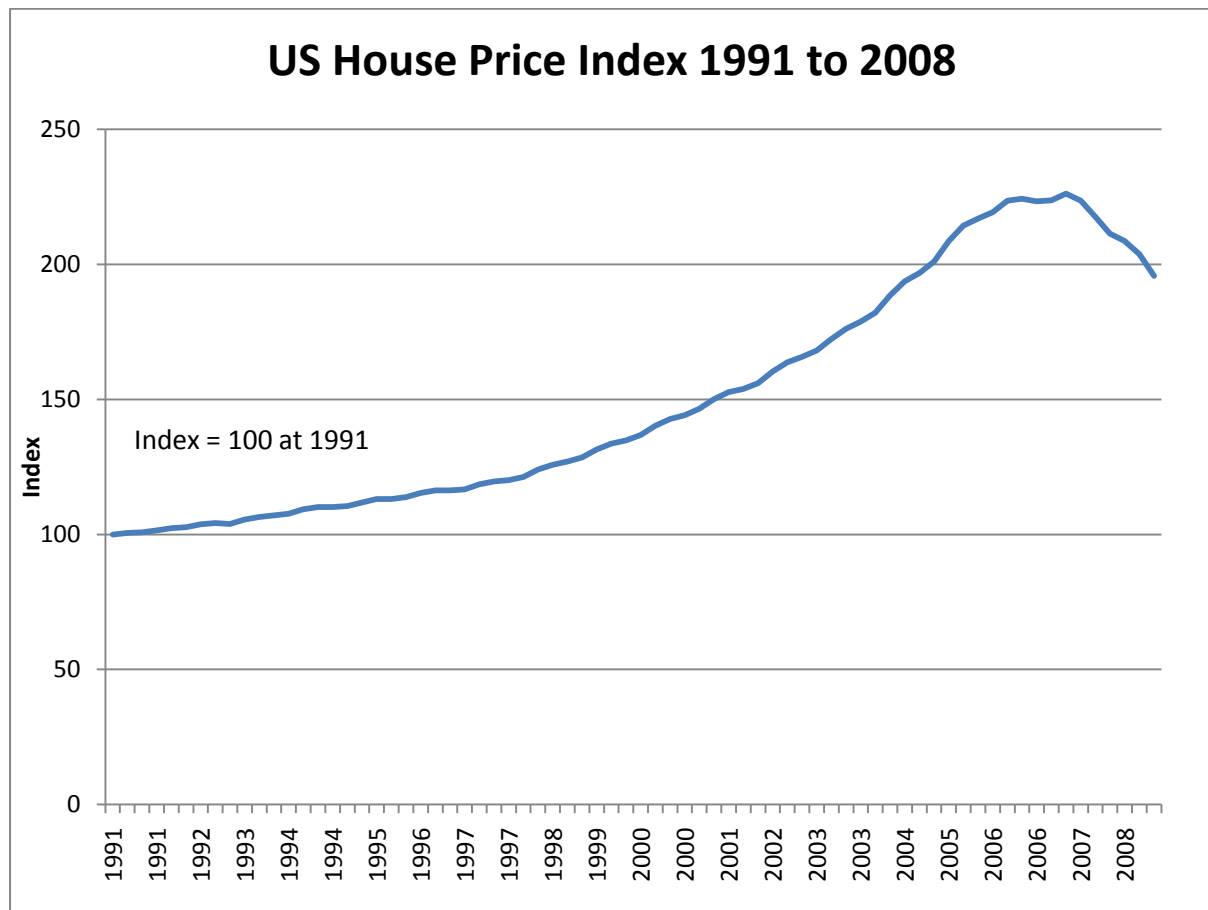
McSweeney (2009) agrees that the GFC was sparked by the collapse of the housing market, principally in the US. Reddy (2010) goes further suggesting that the “main proximate sources of the crisis were 15 or 20 financial conglomerates” (Reddy 2010, p. 131). These global financial institutions which fuelled the credit boom were complicit in the “unsound risk management practices” (Bernanke 2009, p. 1). McSweeney (2009) also directs blame towards the financial institutions sector and claims that with adequate financial reserves these institutions would have been able to withstand the shocks from the GFC:

³ Ben Bernanke, whose background is in economics, was a Chairman of the US Federal Reserve between 2006 and 2014. Prior to his role with the Federal Reserve, Bernanke was the Federal Governor and Chairman of the Council of Economic Advisers in President George W. Bush’s administration.

But too many were over-exposed not only because of their careless acquisition of ‘toxic assets’ – often knowingly or unwittingly created by sellers from their risky and even distressed liabilities – but also as a result of unwise and speculative activities (McSweeney 2009, p. 836).

Figure 1 shows the escalation of the housing bubble until its collapse in 2007.

Figure 1 - US House Price Index 1991 to 2008

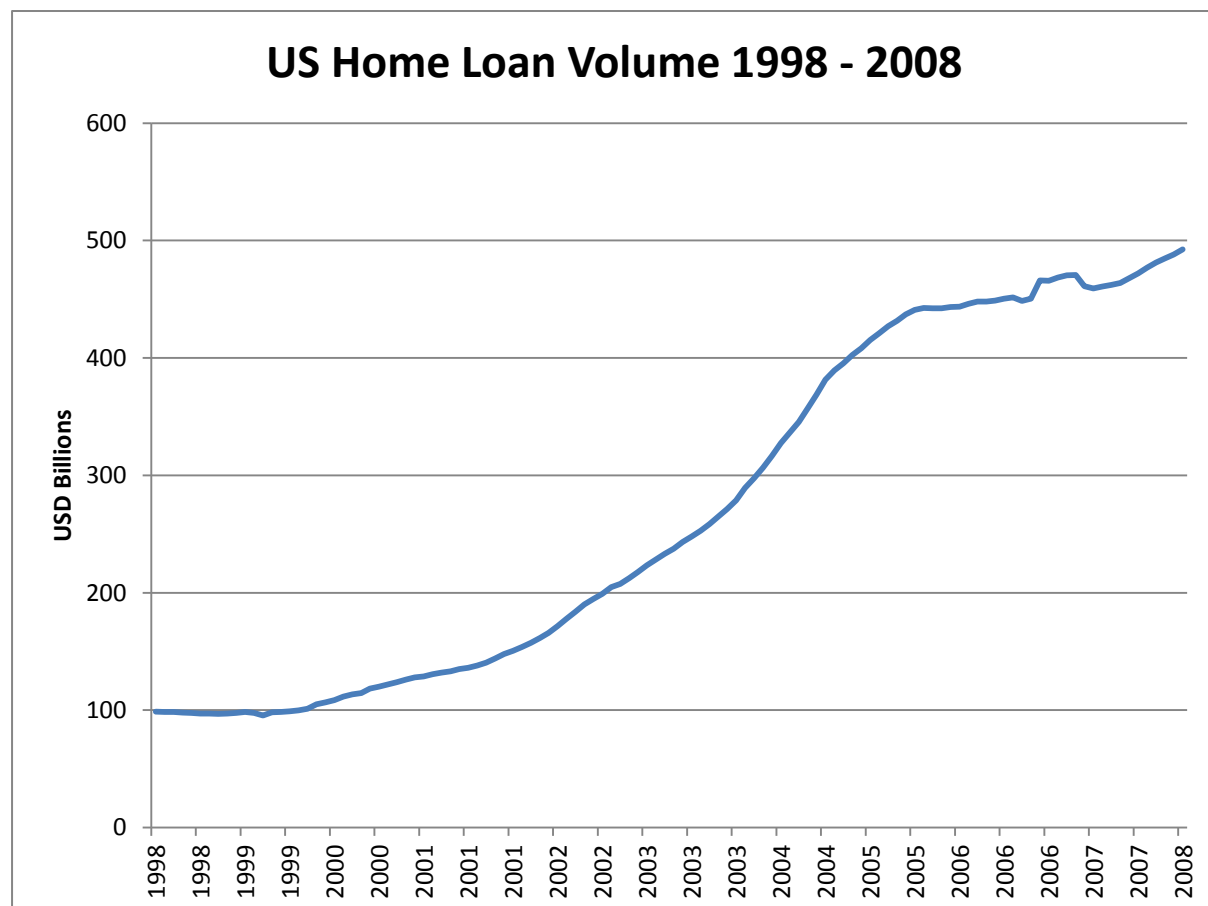


Data Source: Data from the graph was extracted from the Federal Housing Finance Agency database (Federal Housing Finance Agency 2010).

Other literature, for example, focuses on specific causes such as the inherent conflicts of interest between CRAs and financial institutions which led to problematic credit ratings which is well covered by Barth et al. (2009), Brunnermeier (2009), Calomiris (2009b), and Caprio et al. (2008). Section 8.3 has a detailed discussion on the CRAs. Taylor (2009b) however, claims the Federal Reserve’s accommodative monetary policy produced an environment conducive to the formation of the asset bubbles which preceded the crisis, arguing it to be more than a liquidity crisis. Wallison (2009) tends to focus on the US government’s inept attempts to regulate Government Sponsored Enterprises (GSEs) and the role played by financial institutions, in particular the licensed banks which relaxed lending guidelines as a

response to the Community Reinvestment Act (CRA Act) which is discussed later in this chapter. Holcombe and Powell (2009) similarly support the view that as many government agencies were focused on increasing home ownership, they concurrently influenced banks to lower underwriting and credit risk standards. The loosening of credit risk standards supplied the impetus for an increasing supply of credit, particularly to the housing market – refer Figure 2 for a graph of home lending volumes in the US from 1998 to 2008.

Figure 2 - US Home Loan Volumes for Period 1998 to 2008



Source: The data from the graph was extracted from the Federal Reserve database (Federal Reserve Bank of St Louis 2015b).

As lenders searched for more lending opportunities in the early 2000s, they lowered their credit risk standards and began to accumulate subprime mortgages. Mayer et al. (2009) found there was a significant growth of subprime loans comprising loans mostly with no deposit or documentation between 2001 and 2006. Mian and Sufi (2009) also found significant growth in subprime lending and related it to higher default rates and the use of securitisation as a vehicle in creating greater capacity for the industry to expand lending in this segment of the market. As higher volumes of subprime loans were written, those banks which were becoming heavily involved in this segment of the market experienced higher levels of

problem loans. Dell’Ariccia et al. (2012) confirmed this trend and associated delinquency rates with areas in which credit risk criteria were lowered by home lenders.

Yeoh (2010) and Aluchna (2013) argue that governance practices within both government and industry are largely to blame for the GFC. Yeoh (2010) relies on observations of relevant banking practices common within the industry to support this contention. Taylor (2009a) claims that inconsistent government intervention worsened the crisis, citing government support of some financial institutions such as the American International Group Inc (AIG) and their creditors, but not others, for example LB, which was allowed to fail. The government’s inconsistent treatment of troubled organisations during the crisis was handled without a clear framework.

Jaffee (2009) argued that the government should regulate investment banks quickly to avoid the moral hazard which was exacerbated following the bailout of US investment bank Bear Stearns. At this time regulators orchestrated a rescue through a merger with JP Morgan Chase. Jaffee (2009) conceded that further regulation was required given the urgency and potential major impact on the US economy.

On the other hand, Rosenberg (2009) raises the moral hazard problem to argue against a government interventionist approach. He claims that the real “systemic risks are due to the moral hazard engendered from market expectations of a LB bailout following the government bailout of Bear Stearns” (Rosenberg 2009, p. 78). He therefore argues against the risk of government intervention as a response to the GFC and claims the market response during the period immediately prior to the LB default was unpredictable due to previous government interventions. The differing stance taken by Rosenberg (2009) compared to Jaffee (2009) highlights the inconclusive views in academic literature on whether more or less regulation is the answer to avoiding a repeat of the GFC.

Although the depth and nature of regulation is important, of equal importance are the perception and characteristics of the relationship between regulators and industry participants (Sinclair 2010). The importance of a transparent and distinct separation between industry participants and their regulators is identified as an area which is under-researched. This thesis asks the question: could it be possible that the inconsistent approach to supporting organisations as espoused by Taylor (2009a) was partly based on the influence of the actors or their varying uses of power within and between the respective organisations and regulators? The answer to this question, not addressed specifically by Taylor, constitutes a contribution to the understanding of this era of financial history.

A deeper understanding of the various causes of a financial crisis will assist in identifying the underlying protagonists. Sinclair (2010) notes it is helpful to contrast two main ideologies of understanding crises, exogenous and endogenous perceptions. Firstly Sinclair (2010) argues the exogenous approach to financial crises was originally espoused by free market thinkers

such as Adam Smith, Friedrich von Hayek and Milton Friedman. The overriding principle is that markets, when unimpeded, are efficient allocators of resources and any deviation from a normal state of the market would explain a crisis. Given the assumption of efficient markets, this approach blamed external causes, such as government intervention, as the instigator of a crisis.

Secondly Sinclair (2010) notes the contrast endogenous approach, which claims that financial crises begin primarily within the financial markets community:

Central to the endogenous perspective is the idea that market traders do not merely integrate information coming from outside the markets in the wider, real economy, but are focused on what other traders are doing, in an effort to anticipate their buy/sell activities, and thus make money from them (or at least avoid losing more money than the average)... On this account, finance is subject to the pathologies of social life (Sinclair 2010, p. 95).

Thus, this alternative perception of how the financial markets function and produce crises features aspects of social interaction such as rumours, norms, and practices, and is subject to social phenomena such as interplays of power and influence. This thesis adopts the endogenous approach as a way of understanding and illustrating the underlying causes of the GFC. This approach goes beyond much of the existing literature on technical causes which ignore the cultural and behavioural explanations.

The preceding section outlined various approaches identified in the literature that are used to understand the causes of the GFC. The remaining part of this chapter uses Sinclair's (2010) framework to focus on the endogenous approach and deals with two key background themes which set the context for this thesis. That is, insufficient capital regulation prevailing at the time, and the neo-liberal approach to financial market legislation which led to the former. This contextual background allows for a fuller understanding of the external environmental conditions within which the social interactions of financial market participants occurred.

2.1 Insufficient Capital Regulation

An important aspect of the GFC was the relatively high leverage, or expressed in terms of capital, an insufficient level of capitalisation of financial institutions in general and in particular, the US investment banking industry. A requirement for minimum capital levels has traditionally been the principle prudential tool used by regulators to manage risk profiles of banks, pursuant to the Basel regulations as described below. The regulatory framework for investment banks in the US however, did not employ the same focus on minimum levels of required capital based on risk exposure as the banking industry. The differences lay not only

in the minimum levels of capital required but the types and extent of risks that were to be covered by such capital. This problem of insufficient capital in the investment banking industry was created by two factors: firstly the push for higher leverage by investment banks so they could take advantage of the increased profitability from the 'leverage effect' (refer section 7.3.1 for a detailed discussion on the leverage effect); and secondly, the lax requirements relating to the capital adequacy of investment banks prior to the GFC. See section 4.4.8 for a detailed discussion on the voluntary nature of compliance to capital regulations by the large US investment banks.

Financial institution failures can generally be classified into two main categories: Banks, and Non-Bank Financial Intermediaries (NBFIs). The number of US financial institution failures between 2007 and 2014 is set out in Figure 3.

Figure 3 - US Financial Institution Failures 2007 - 2014

Year	2007	2008	2009	2010	2011	2012	2013	2014
Number of Financial Institution Failures	3	24	140	157	92	51	24	18

Source: (Federal Deposit Insurance Corporation 2016).

Figure 3 shows a steep escalation in the number of failures following the GFC period of 2007/2008, peaking in 2010 with 157 failures. These failures occurred despite the prevailing regulatory framework which suggests an inherent weakness in the ability of regulations to protect financial institutions from bankruptcy. Licenced banks (as opposed to investment banks) in the US are a highly regulated group whose risk management frameworks and practices are largely influenced by various regulators⁴. The key regulator for US banks is the Federal Reserve System, which at the time of the LB collapse adopted the prudential guidelines stipulated by the Bank of International Settlements known as Basel II⁵.

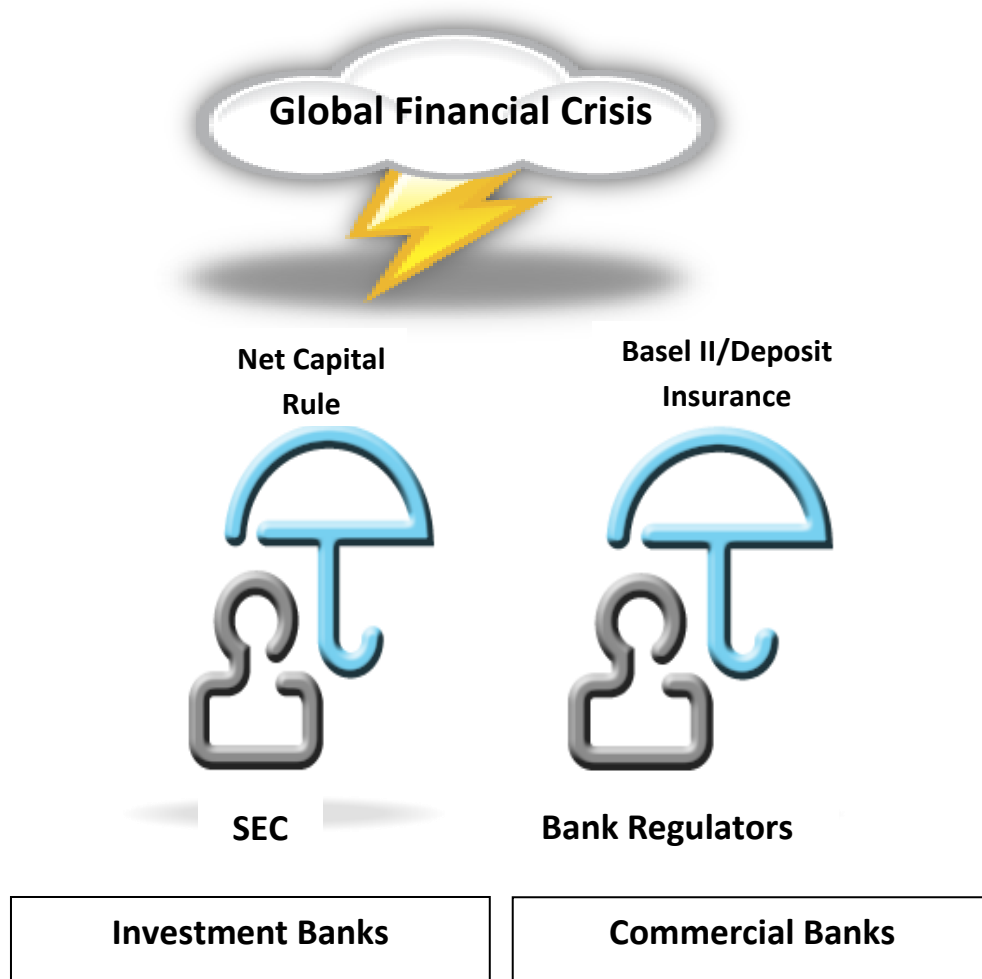
⁴ Bank regulators in the USA consist of Federal Reserve System, Comptroller of the Currency, Federal Deposit Insurance Corporation, Department of Justice, Securities and Exchange Commission and State Boards or Commissions.

⁵ Basel II refers to a set of prudential guidelines issued by the Basel Committee on Banking Supervision, an adjunct of the Bank of International Settlements (the overseer of global prudential supervision of banks) which

A major sub-group within the NBFIs sector comprises the investment banking industry. The activities of the US investment banks were however subject to a less stringent regulatory environment as they did not fall under the same regulatory umbrella as banks as illustrated by Figure 4. Instead they were officially supervised by the US Securities and Exchange Commission (SEC) and this supervision was largely voluntary (Sirri 2008). See section 4.4.8 for a detailed discussion of the voluntary nature of regulation impacting the large US investment banks. Investment bank activities conform to a generally common business model. The framework driving investment banks' business activities is created and managed by an organisation's leadership through conscious decision-making, ranging from high level strategic to tactical operational decisions within a regulatory environment which during the pre-GFC period was shown to be deficient (McSweeney 2009).

forms the basis of formal rules for adoption by prudential supervisors around the world. The US Federal Reserve adopted most of the recommendations of Basel II on 1 April 2008.

Figure 4 - Regulatory Umbrellas for Banks versus Investment Banks



The differences in the regulatory framework between the banking and investment banking industries, and the degree of the regulatory strictures were to be tested during the GFC. In the timeline of the GFC, it was at the approximate point of LB's bankruptcy when the pendu-

lum had swung from the neo-liberalist⁶ approach to a more interventionist⁷ approach as the government attempted to stave off an even deeper crisis. Examples of government intervention were the arrangements to rescue failing institutions such as AIG, the large government sponsored mortgage institutions - Freddie Mac and Fannie Mae, Morgan Stanley, Bear Stearns, Washington Mutual, Wachovia Corporation, and Citigroup. The US government also provided its guarantee to enhance liquidity of financial institutions' money market accounts with Federal Reserve programs to purchase commercial paper issued by financial institutions. A more significant assistance package was established through The Emergency Economic Stabilization Act, which implemented the Troubled Asset Relief Program (TARP), enacted on October 3, 2008. This government intervention reintroduced a degree of liquidity to the market which assisted in the short term funding needs of US banks, possibly preventing a complete loss of confidence in the financial markets and an even deeper crisis. The interventionist approach was an admission that the laissez-faire approach had serious shortcomings, especially in times of crises.

Ultimately the remaining investment banks were taken under the Federal Reserve System's supervisory control by either being classified as bank holding companies or being merged with other bank holding companies. This move achieved a reprieve for both Morgan Stanley and Goldman Sachs from the liquidity crisis which affected all investment banks. The status of a bank holding company qualified both these investment banks for official protection and emergency funding by the Federal Reserve, as well as the associated market confidence that comes with the status and the capital regulations which applied to all banks. These and other subsequent financial aid programs represented a reversal from the neo-liberalist approach to financial regulation which permeated through the government and regulatory sectors prior to 2008.

⁶ Neoliberalism is an ideology that supports a laissez faire approach to the management of an economy. The reliance of this ideology is on allowing markets to be subject to unobstructed market competition. The notion is backed by a belief that the markets are best able to allocate limited resources within an economy and therefore are able to maximise economic growth. In order to facilitate free market operation, government intervention is discouraged (Smith 2016).

⁷ An interventionist approach involves a government intervening in the market process by employing economic and regulatory policies which attempt avoid market failure and produce positive economic and social outcomes. This government intervention is at odds with the neoliberal approach which supports a free market approach without government intervention.

2.2 Neo-Liberal Approach to Financial Market Legislation

The US executive government has for decades been pre-occupied with the affordability of housing for the underprivileged classes. In 1977, the Carter administration introduced the CRA Act which was intended to support the borrowing needs of low income individuals and families residing in underprivileged communities. The CRA Act effectively designated geographic areas as zones of extreme poverty, a process called 'redlining' and required banks to establish branches in these zones and allocate a proportion of their loan portfolios targeted to home mortgages in these zones. The CRA Act provided for penalties including bans on the establishment of additional branches in wealthier regions if banks failed to meet the required portfolio allocations (Hylton & Rougeau 1999, pp. 164-6). The pressure on banks from government was profound: "banks were told to use innovative or flexible methods in lending to meet the goals of the CRA Legislation" (Hossain & Rezaul 2004, p. 57). Given these directives, banks were lending to customers that would otherwise not meet their credit criteria and consequently the quality of the home lending portfolios decreased. During this period, the Federal Reserve's accommodative monetary policy kept interest rates relatively low. Homeowners took advantage of this to either purchase new homes or upgrade. As demand for home loans increased so did the balance sheets of banks:

Riskier mortgage standards by banks were not the consequence of deregulation; rather the banks were compelled to change the standards by new regulations at the behest of community groups. Again, this was a political failure as the Administration sacrificed the greater social good to appeal to narrow constituencies (Tarr 2010, p. 2).

In 1982, the Reagan administration, often cited as one of the most neo-liberal governments in the past several decades, introduced an act known as the Alternative Mortgage Transactions Parity Act (AMTPA), which effectively permitted non-bank financial institutions to offer adjustable rate mortgages (ARM). These mortgages were influential in spurring home loan growth, as the key feature of the product involved an interest rate which was heavily discounted in the initial period – usually 12 to 18 months, thereafter increasing substantially to a variable rate often many percentage points higher than the initial rate. This amendment offered the banking industry greater marketing power and flexibility for borrowers in their product choice. Combined, these enhancements provided greater access to home loan financing to borrowers.

The accommodating attitude towards the underprivileged segment of the community continued under the Clinton administration which in 1995 passed an amendment to the CRA Act commonly referred to as the CRA Expansion Act (CRA Expansion). Barr (2005) notes the CRA Expansion facilitated easier access to mortgage finance for low income and minority

group households, and resulted in an increase in the proportion of the US banks' loan portfolios related to distressed inner city areas. Naturally as this segment of the banks' lending business grew, so did the credit risk of their portfolios.

George W. Bush was US President from 2001 to 2009 - an important period prior to the GFC in which neo-liberal principles towards the investment banking industry prevailed. Bush's presidency was characterised by extreme advocacy of free market principles: "This administration made decisions that allowed the free market to operate as a bar room brawl instead of a prize fight" (Becker et al. 2008).

During the Bush administration, US house prices increased significantly – refer to Figure 5 for a graph showing the escalation of US house prices. Bush had established an ambitious goal to create housing for a large proportion of minority groups. According to Becker et al. (2008) "he had a plan to increase home ownership by US minority group families to 5.5 million by the end of the decade [2000s]". His strategy was to use the financial institution sector to carrying out his policy:

Through his homeownership challenge, the President called on the private sector to help in this effort. More than two dozen companies and organizations have made commitments to increase minority homeownership - including pledges to provide more than \$1.1 trillion in mortgage purchases for minority homebuyers this decade (United States White House 2004).

Low income families however were still confronted with the challenge of meeting the initial deposit for a home loan. Bush solved this problem by establishing the American Dream Down Payment Act which would provide USD 200 million per annum to assist approximately 400,000 low income families meet their deposit requirements (United States White House 2004).

According to Becker et al. (2008), Lawrence Lindsay, Director of the National Economic Council, and assistant to President Bush on economic policy, acknowledged that the White House was aware of the growing housing bubble, however had ignored it given any action to deal with it would have affected the President's home ownership policy targets.

The passing of new legislation to accommodate narrow constituencies and enable a deterioration of loan portfolio quality had as much a detrimental effect in the lead up to the GFC as did deregulation. Political influence is therefore considered a contributory cause of the GFC even though indirect. Tarr (2010) goes further to associate the root cause of the GFC to a political malfunction:

Politicians, however, often prefer to mandate a regulation on firms to achieve a political objective, since this allows them to avoid exposure of the costs of their programs while obtaining support from narrow constituencies. In this further sense, the financial crisis is, at its root, a political failure (Tarr 2010, p. 3).

The repeal of another piece of legislation created an environment which amongst the ‘too big to fail’⁸ syndrome encouraged riskier behaviour amongst the investment banking and banking industries. For the first time since the enactment of The Glass-Steagall Act (GSA) following the Great Depression of the 1930s, commercial banks, investment banks, securities firms and insurance companies were allowed to merge. The enabling act, commonly referred to as The Gramm Leach Bliley Act (GLBA), also known as the Financial Services Modernization Act of 1999 effectively repealed, in part, the GSA. The combining of operations of banks with other non-bank financial institutions is often cited as a cause of the Great Depression. A major reason for the non-consolidation of investment banks and licenced banks was the concern that the relatively high risk activities of an investment bank could adversely impact on the operations of a licenced bank (potentially in the form of a bankruptcy) and this in turn would harm the entity’s depositors. The GLBA for example, ratified the Citigroup consolidation of Citibank (Commercial Bank), Smith Barney (securities firm), Primerica (Insurance and loans) and Travellers (Insurance). Furthermore, the GLBA failed to provide any meaningful regulatory oversight of the investment banking industry either through the SEC or any other governmental agency leading to the voluntary regulatory regime mentioned above.

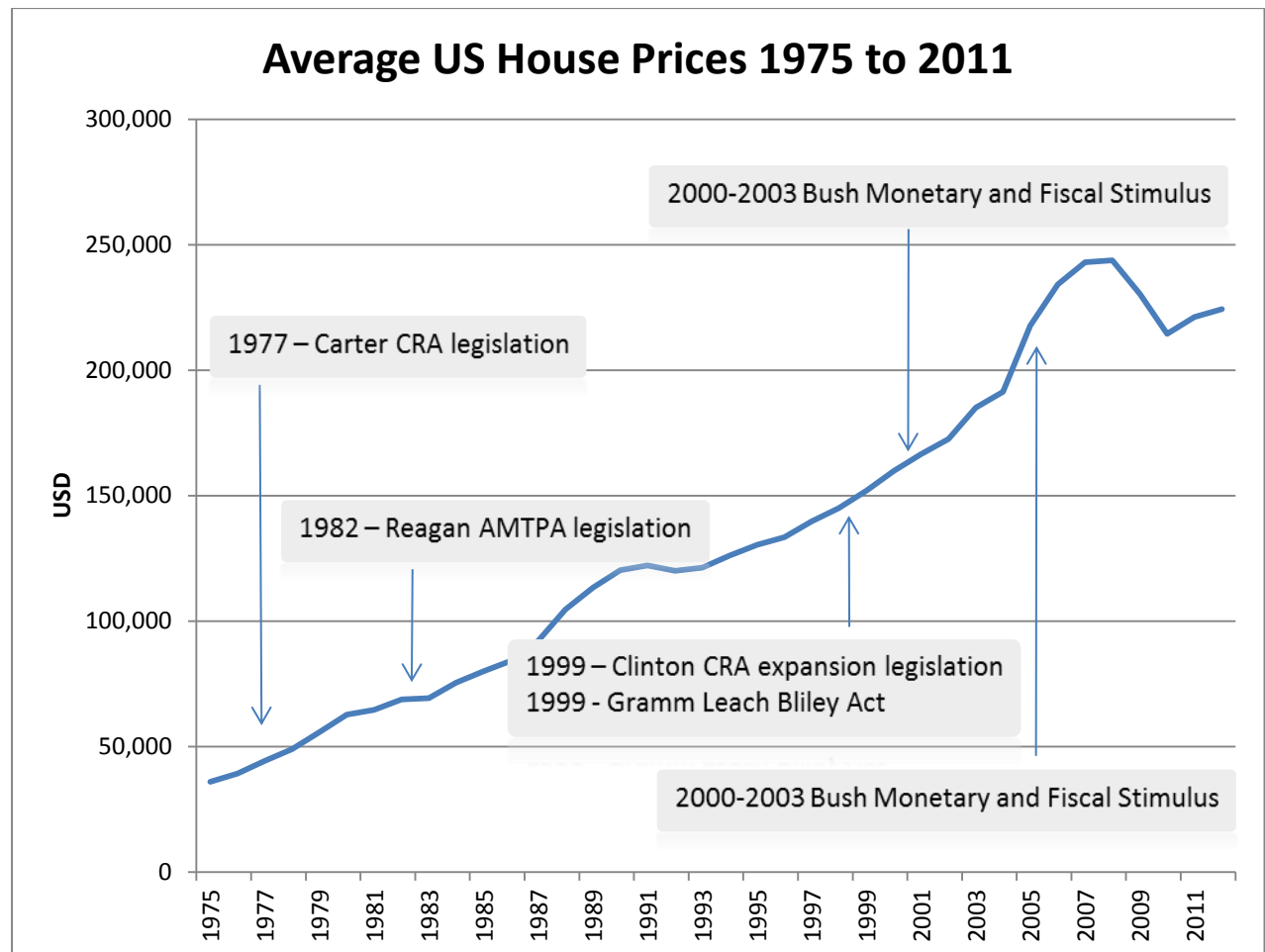
One of the most accommodative pieces of legislation, favourable to the investment banking industry was The Commodity Futures Modernization Act 2000 (CFMA). This Act exempted financial institutions from regulation in relation to their derivatives activities and importantly precluded risks associated with derivative positions from capital adequacy requirements. Without restriction, the investment banks were able to expand their derivatives trading businesses exponentially and thereby radically escalate their risk profiles without supervision. Further examples of the deregulation of the investment banking industry are outlined in Appendix A.

A depiction of the combined impact of the enactment of a selection of the accommodative legislation is represented in Figure 5. It is argued that this legislation fuelled an increasing house price cycle which culminated in the commonly referred to ‘housing bubble.’ The

⁸ The "too big to fail" concept maintains that large corporations, which are systemically important to the economy should not be allowed to fail as their failure would have dire economic and social consequences. The expectation is for government to orchestrate a bailout if such large organisations approach bankruptcy.

graph below is merely intended to reveal the impact of some key pieces of legislation for illustrative purposes only and is not intended to represent a comprehensive compilation of legislation. Moreover the timeline extends over the latter period covered by this thesis which ends with the bankruptcy of LB on 15 September 2008.

Figure 5 - US House Prices and selected US legislation 1975 to 2011



Source: The data fro the graph was extracted from the Federal Reserve database (Federal Reserve Bank of St Louis 2015a).

2.3 LB – Subject of the Case Study

It is ironic that the financial institutions which contributed significantly to the credit boom were themselves counted amongst the casualties of the credit crunch that consumed many institutions. For example, Bear Stearns was forced to merge with JP Morgan Chase via an acquisition on 30 May 2008 (Waggoner & Lynch 2008); LB filed for bankruptcy on 15 September 2008 (Wilchins 2008); AIG underwent a virtual nationalisation when the US Gov-

ernment acquired an effective 79.9% ownership interest on 16 September 2008 (Webel 2013); and Wachovia Bank was taken over by Wells Fargo on 31 December 2008 (Wells Fargo & Co 2009).

This thesis uses a case study method using LB as its subject to elucidate the dysfunctional behavioural and institutional influences that prevailed from three perspectives: within LB itself; between LB and its stakeholders; and between the investment banking industry and external organisations including regulators, legislators, accounting standard setters and CRAs. The case study extends to 15 September 2008, when LB declared bankruptcy. When it begins is driven by the historical context which is detailed in CHAPTER 4 and CHAPTER 5 with the history of the investment banking industry and LB respectively. Therefore as the history of the US investment banking industry can be traced to the beginning of the American Revolutionary War in 1775 (the Revolution), this date has been used as the starting point.

LB was selected for the case study as it was the only US investment bank officially allowed to fail by entering bankruptcy. It is differentiated from other failing investment banks which avoided bankruptcy such as Bear Stearns, which was forced to merge with JP Morgan Chase, and Merrill Lynch & Co. which was sold to Bank of America Corp. Regarding the remaining two major US investment banks, Morgan Stanley shut down part of its trading desk as a consequence of the GFC whilst Goldman Sachs retained all its operating divisions and on September 22, 2008 together with Morgan Stanley, announced that they would become traditional bank holding companies, which as mentioned above in this section, are regulated by the Federal Reserve (Gandel 2009). Therefore Goldman Sachs was the only investment bank of its peer group which survived the GFC in its original form whilst the other investment banks were either merged with other entities or restructured their operations in order to continue operating.

Chapters 4 and 5 explore the personal characteristics and behaviours found in US investment bankers since the formation of the industry and likens certain traits to those found in the senior management eschelons of LB. LB was a full service investment bank and carried out investment bank activities similar to those of its peer group which included Goldman Sachs Group, Morgan Stanley, Merrill Lynch and Bear Stearns. JP Morgan Chase carried out investment banking activities and could therefore be considered as part of the peer group, however it was a fully licensed bank at the time and is generally excluded from peer group comparisons. See section 7.2 for a full description of LB's business activities. Figure 6 sets out the relative size of each investment bank based on market capitalisation and number of employees as at 2007, in order to provide an overview of the relative position of each investment bank within the peer group.

Figure 6 - Major US Investment Banks 2007 by Market Value and Number of Employees

Investment Bank	Highest market value 2007 USD Billions	Average number of employees 2007
Merrill Lynch	150.89	64,200
Goldman Sachs	107.05	30,522
Morgan Stanley	83.34	56,000
Lehman Brothers	59.38	28,556
Bear Stearns	20.47	13,700

Source: (Arslan 2009).

This chapter provided a background to the GFC outlining the various causes, from the bursting of the housing bubble to the resulting liquidity crisis in the financial markets. Underpinning these adverse developments were two important regulatory related problems: insufficient capital regulation and a neo-liberal approach to financial market legislation. The following chapter outlines the theoretical framework, methodology and method used in this study. The theoretical framework provides the lens through which this study is interpreted, and describes the broad philosophical underpinning of the case study method which is supplemented by empirical analysis.

CHAPTER 3 **THEORETICAL FRAMEWORK, METHODOLOGY AND METHOD**

This chapter introduces New Institutional Theory and Clegg's (1989) Theory of Power, to better understand the historical context, events, personalities, and culture which prevailed prior to and during LB's collapse. This case study using this framework enables recurrent themes of the interplay of power and institutional pressures to explain the behaviours driving important managerial decisions. This thesis augments New Institutional Theory with a Theory of Power, to unravel the pertinent influences from key sources, to provide a comprehensive view of LB's downfall.

The chapter commences with an outline of the theoretical framework used in this thesis. Firstly Di Maggio & Powell's (1983) New Institutional Theory is introduced and its relevance to the case study is discussed. This is followed by an outline of Clegg's concept of three circuits of power, which is considered important as it fills a deficiency found in New Institutional Theory by explaining the power relations between individual actors and between actors and organisations. The chapter then describes the methodology and method used in this study. It is argued that a case study approach emphasises the importance of acknowledging the social, political and economic contexts of LB's downfall (Burrell & Morgan 1979; Chua 1986; Gioia & Pitre 1990; Hassard 1991; Hopwood 1987).

3.1 Theoretical Framework

This section outlines institutional influences on the investment banking industry and more specifically on LB prior to its collapse. New Institutional Theory is a derivation of the broader institutional theory which has attracted various interpretations since the first version developed by Weber (1905). As well as a discussion on New Institutional Theory this chapter includes a discussion on Clegg's (1989) Theory of Power which is used to augment New Institutional Theory to better explain the abovementioned dynamic influences at work within the investment banking industry.

3.1.1 Institutional Theory and Theory of Power

Institutional theory, which asks "provocative questions about the world of organizations" (Scott 1995, p. xiii), is capable of providing insights about organisational behaviour, whilst acknowledging the characteristics of individual organisations. However it falls short of offer-

ing a comprehensive understanding of the interplay of power which is exposed through incisive analysis of various forms of data and historical accounts (Clegg 2010; Leca & Naccache 2006).

The development of an appropriate theoretical framework for this study encompasses features of both New Institutional Theory and Clegg's (1989) Theory of Power. Clegg (2010) identifies an omission in the literature covering institutional theory: "Issue is taken with the relative absence of the analysis of power from many leading institutional theory accounts of organisations" (Clegg 2010, p. 4). The role of actors⁹ in institutional theory is at best fuzzy but can be addressed by considering a framework augmenting New Institutional Theory with a Theory of Power.

The organisational culture of LB was shaped not only by external institutional forces but by the interplay of internal power relations. New Institutional Theory has been criticised as it does not adequately deal with power. This notion is supported by (Brint & Karabel 1991) who argue that the role of power in institutional processes is neglected in favour of cultural domination. Additionally, (Perrow 1986) suggests that institutional theory has downplayed the role of self-interest. This concept is important in the case of LB's downfall as the domination of self-interest, particularly by the CEO was an important factor in the misguided decision making prior to the firm's downfall. Self-interest is however adequately dealt with by Clegg's (1989) Theory of Power. This theory enables the linking of the CEO's own self-interest to that of the organisation's and is able to highlight it as an object of his pursuit of power.

Another shortcoming in the use of institutional theory to describe influences on organisations is in its definition of the organisational field. The organisation field is defined by institutional theory as "those organisations that, in the aggregate, constitute a recognised area of institutional life: key suppliers, resource and product customers, regulatory agencies, and other organisations that produce similar services or products" (DiMaggio & Powell 1983, p. 148). However Clegg (2010, p. 5) argues that the "non-action or absence from a field is a significant form of presence and this element of power has largely been absent from en-

⁹ 'Actors' in this context are either 'rule takers' and/or 'rule makers' (Jackson 2010, p. 63).

agement with DiMaggio and Powell's work". This inclusion of 'non-action or absence from a field' to the definition is incorporated in this thesis.

Clegg's (1989) Theory of Power complements New Institutional Theory as it is able to explain the behaviours of individual actors within LB who were able to exercise power to shape the organisations culture and decision making processes. New Institutional Theory on the other hand is primarily concerned with the application of external institutional forces and therefore doesn't adequately address the internal power relationships. Whilst Clegg's (1989) Theory of Power can be effectively applied to the internal relationships within LB, specifically those between the powerful CEO and his fellow board members and employees, New Institutional Theory can help explain the various outside forces at play which influenced the organisational culture, business model and financial structure of LB. Therefore the application of both theoretical frameworks in this thesis enables coverage of both internal and external forces at play which led to LB's downfall.

Other theoretical frameworks were considered for this thesis, including agency theory, stewardship theory, stakeholder theory, and resource dependency theory. A discussion of these theories is provided in section 10.2.1 including their limitations. The use of both New Institutional Theory and Clegg's (1989) Theory of Power overcomes the various limitations of the alternative theories in addressing the corporate governance failure of LB. A key distinction between the abovementioned group of theories and the two applied in this thesis is that the former theories are generally premised on agency where the focus is on traditional accounting concepts of shareholder wealth. They largely ignore the role of organisational culture and individual power relationships in effective corporate governance which is accommodated by the latter theories respectively.

Regulatory capture theory was also considered. Regulatory capture involves winning a regulatory agency's support by influential and often large commercial or political interest groups whose industry or activities the agency is charged to regulate. The support is usually at the expense of the public in whose interests the regulatory agency is supposed to act, and may take the form of regulations which are advantageous to the interest group. This process leads to the notion that the regulatory agency is being 'captured' or allowing itself to be influenced by the interest group and therefore represents a failure of the regulatory agency (Chalmers et al. 2012; Cortese & Irvine 2010; Königsgruber 2010; Stigler 1971).

In their study of the process by which the International Accounting Standards Board (IASB) developed IFRS 6, *'Exploration for and Evaluation of Mineral Resources'*, Cortese and Irvine (2010) showed how participants in the extractive industries and other interested parties influenced the IASB to produce an accounting standard which accommodated their own preferences. In this case the industry was able to maintain flexibility in its application of the accounting standard by changing the IASB's recommendation contained in their earlier published issues paper. It showed that powerful entities within industry were able to 'capture'

the accounting standards setters to achieve their own ends. Similarly, Konigsgruber's (2010) study found that companies were able to influence the US and European accounting standard setting process by making use of personal relationships with political decision-makers in order to gain leverage over the standard setter. The study found that companies have incentives to lobby political decision makers and the accounting standard setters instead of participating in the due process normally associated with the establishment of accounting standards.

Regulatory capture theory therefore has merits in providing a framework for explaining the power that the investment banking industry had over regulators and is referred to in section 8.2, in particular as it applies to the system of lobbying and use of political contributions in the US. However the theory ignores the influential forces that apply between non-regulatory agencies and individuals.

The following section discusses the evolution of Institutional Theory and is followed by a description of a branch of this theory known as New Institutional Theory which is applied in this thesis.

3.1.2 Institutional Theory- Precursor to New Institutional Theory

Weber, often considered the father of institutional theory, was interested in the overriding influences that organisations exerted on societies. The impact on society from a modern rationalisation process as exhibited by organisations is likened to a "polar night of icy darkness" (Weber 2013, p. 128). The loss of an individual's freedom to practice their own values is captured well by Weber: "The increasing rationalisation of human life traps individuals in an iron cage of rule-based rational control" (Weber 1905, p. 181). The 'iron cage' metaphor, a translation by Talcott Parsons of the German "stahlhartes Gehäuse" Baehr (2001, p. 154) is an attempt to conjure an image of the human subject under bureaucratic capitalism as within a 'shell as hard as steel'.

What Weber feared was not private capitalism per se but its rentier parasite, not individualism but the accustomed Gehäuse of bureaucratic regimentation, not democracy but rule-governed conformity, not administration in its place but the bureaucratic stultification of all sectors and spaces of life (Baehr 2001, p. 167).

A further development of Weber's descriptions involves institutionalisation being viewed as a process that should be viewed in the context of an organisation's history and constituting an interdependence between the organisation and the actors within it (Jackson 2010; Selznick 1957).

Selznick (1957, pp. 16-7) describes the effect on organisations as follows:

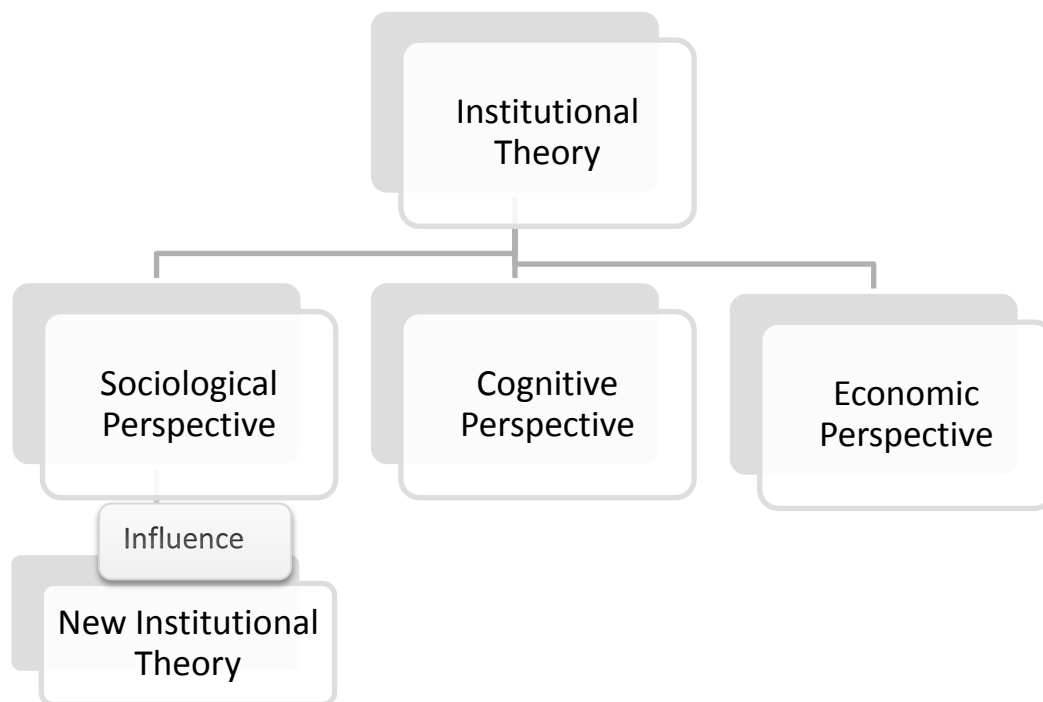
It (institutionalisation) is something that happens to an organisation over time, reflecting the organisation's own distinctive history, the people who have been in it, the groups it embodies and the vested interests they have created, and the way it has adapted to its environment.

Given that institutionalisation is an important aspect of an organisations history two chapters of this thesis consider the institutional forces at play during the history of the investment banking industry and LB. Institutional theory is useful in understanding organisational relationships. Garud et al. (2007) summarise academic literature on the influences on institutions from three perspectives: the economic; cognitive; and sociological. Within the institutional economics field, for instance, uncertainties relating to outcomes resulting in transaction costs which may prejudice an organisation are minimised. These transaction costs could arise from contractual arrangements between organisations. The repetition of the contractual process resulting from an institutionalisation of behaviour tends to reduce variability in contractual practice and any potential for opportunistic behaviour (Coase 1937; Williamson 1985). Literature on the cognitive perspective focuses on the way in which actors interpret otherwise ambiguous symbols in a common perspective. The individuals therefore construct a common meaning which leads to consistent cognitive activities (Geertz 1973). Actors interact “in a consensually validated grammar for reducing equivocality by means of sensible interlocked behaviour...[and therefore convert]...ongoing interdependent actions into sensible sequences that generate sensible outcomes” (Weick 1979, p. 3). Therefore the cognitive perspective allows an institution to interpret ambiguous symbols and information to construct a common meaning (Gioia & Chittipeddi 1991, pp. 434-5). This perspective on institutional theory explains the powerful hidden influences of conformity between organisations, “moreover, the shared nature of these cognitive frames makes it difficult to stray far from them in either thought or deed” (Garud et al. 2007, p. 159).

Institutional theory can also be viewed from a sociological perspective whereby institutions are considered to be able to influence groups to conform to an accepted view of the world and such conformity attracts validation of behaviour. It is “a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values, beliefs, and definitions” (Suchman 1995, p. 574). The resultant influence causes tension that constrains an actor's activity to conform within an institutional field. “Some actions...come to be seen as legitimate and may even be prescribed, making it difficult for actors to deviate from them” (Garud et al. 2007, p. 959). One of the influences of the sociological perception of institutional theory is the development of New Institutional Theory used in this thesis.

A simple diagrammatical representation of where New Institutional Theory fits under the broader banner of institutional theory is set out below:

Figure 7 – Garud et al.’s (2007) positioning of New Institutional Theory



Section 3.1.3 introduces New Institutional Theory, which was originally developed by Meyer and Rowan (1977), followed by an outline of Clegg’s (1989) Theory of Power which was developed through several iterations (Clegg 1975, 1979; Clegg & Dunkerley 1980). The chapter concludes by augmenting New Institutional Theory with Clegg’s Theory of Power to create a theoretical framework which accounts for institutional pressures, the role of key actors as well as the power interplays between various actors and between actors and organisations which seek to shape and influence their environments.

3.1.3 New Institutional Theory

The abovementioned sociological perspectives of institutional theory were developed in the 1960s and 1970s with key literature by Luckmann and Berger (1966), Meyer and Rowan (1977), and Zucker (1977). This strand of the theory known as New Institutional Theory, proposes that new “institutional rules function as powerful myths” which “often conflict sharply with efficiency criteria” (Meyer & Rowan 1977, pp. 340-1). It is concerned with social structures such as schemas, rules, norms and belief systems.

Meyer and Rowan (1977) developed Weber’s themes by describing organisational structures as “reflections of rationalised institutional rules” (Meyer & Rowan 1977, p. 340). According to Scott (1995, p. 13) these structures contained “shared knowledge and belief systems” which are “built into society as reciprocated typification or interpretations” (Meyer & Rowan 1977, p. 341). New Institutional Theory argues that institutions are social structures that are highly resilient, are understood within a culture, are normative in nature (they tell

us what we should do), and are regulated, that is they are enforced. These social structures are communicated in the field through symbols, relationships, routines and artefacts. They provide stability for organisations, and operate at both the global and organisational levels. These social structures are buffered or protected by a decoupling process which is described by Meyer and Rowan (1977) as the formation and safeguarding of divergences between organisational structure including policies, on the one hand and practices on the other.

Because attempts to control and coordinate activities in institutionalized organizations lead to conflicts and loss of legitimacy, elements of structure are decoupled from activities and from each other (Meyer & Rowan 1977, p. 357).

Decoupling conflict from social institutions is necessary to cope with institutional inconsistencies that arise, allowing such pressures to appear to be dealt with rationally. Decoupling allows unresolved matters to avoid scrutiny, allowing ceremonial compliance, and thus giving the perception of commitment and maintaining legitimacy.

New Institutional Theory offers a theoretical perspective through which we can analyse how the typical investment bank model evolved, and understand investment banker behaviour during the boom times of pre-GFC. New Institutional Theory helps us understand and explain how the social structures of the investment banking industry at the global level, and LB at the organisational level, are created, adopted, adapted and in time fail or change. Weick (1996, p. 567) notes that organisations such as investment banks can be “externally controlled by their social contexts”, which are constructed by “what people take for granted and consider legitimate and are willing to pay as the price of being included”. The investment banking culture had developed a commonality which is demonstrated throughout this thesis. This culture established a structure of internal morality for behaviours and practices that were evident prior to the GFC. The behaviours and practices were socially justified in view of their common usage within the industry and in the shared motivations of individuals which was dominated by the maximisation of profits and bonuses. Institutions can therefore constitute vehicles which offer “stable designs for chronically repeated activity sequences” (Jepperson 2012, p. 145). New Institutional Theory can assist in understanding not only how the investment bank model evolved but why the major US investment banks shared the same model and their employees a common culture.

DiMaggio and Powell (1983) expanded New Institutional Theory by arguing that the universe of organisations is heavily influenced by institutionalised isomorphism. That is, organisations incorporate operational structures, policies and practices which are similar within a particular field. This type of conformity appeals to the perception that ‘normal’ practice is risk averse and accrues legitimacy in the eyes of stakeholders, and not related to whether or not such conformity maximises profits. DiMaggio and Powell (1983) identify three means by which institutional norms permeate an organisational field. These institutional forces are classified as coercive, mimetic and normative. Mizruchi and Fein (1999) and Riaz (2009) ex-

pand on this concept by proposing the notion of “reverse legitimization” (Riaz 2009, p. 28). That is, if organisations are successful, the institutions, such as regulatory authorities which legitimised them are endorsed for supporting this success. He further argues that the mutual legitimisation between an organisation and its regulator gives rise to a “contagion of legitimacy” (Riaz 2009, p. 27). However, when an organisation is revealed to be unsuccessful, as for example, the publication of a bankrupt investment bank, the legitimacy of all investment banks becomes suspect. Riaz (2009) uses New Institutional Theory to help explain the causes of the GFC. He argues that the association between regulators and industry participants is fundamental to understanding the environment prior to the GFC. This complex interplay, he argues, “provides perceptions of legitimacy to both parties” (Riaz 2009, p. 33). Riaz (2009, p. 28) also maintains that certain institutions may not endure “without the active support and sanction of organisations”. This implies that organisations possess latent power which is used to influence the institutions that oversee them. However, Riaz (2009) fails to explain this type of power and how it is used. This thesis therefore fills a gap in the literature by using New Institutional Theory, supplemented by a theory of power to elucidate the use of this power and how it related to the contagion effect which paralysed most US investment banks during the height of the GFC and which led to the ultimate downfall of LB.

Further research into organisational fields identifies that not all fields represent a complete universe and are often divided into sub-fields. Furthermore some fields are subjected to various institutional influences (Powell 2008, p. 4). Edelman (1992), Dobbin and Sutton (1998), and Edelman et al. (1999) noted that individuals working within an organisation have influence over the regulatory process and therefore are able to establish what is considered ‘best’ practice in their particular field. Powell (2008, p. 5) purports “that institutionalisation is a political process, and the success of the process and the form it takes depends on the relative power of the actors who strive to steer it”. Consistent with this concept, this thesis relates the way the investment banking industry sought to influence the accounting standards on repurchase agreements¹⁰ known as (Repos) for their own benefit - refer to CHAPTER 9 for a detailed discussion on the influence over the accounting standard setting process.

¹⁰ A Repo is an abbreviation for repurchase agreement. Repos facilitate short term, (most often from overnight funding to terms of 30 days) by a borrower who pledges securities to a lender as collateral. The pledge is

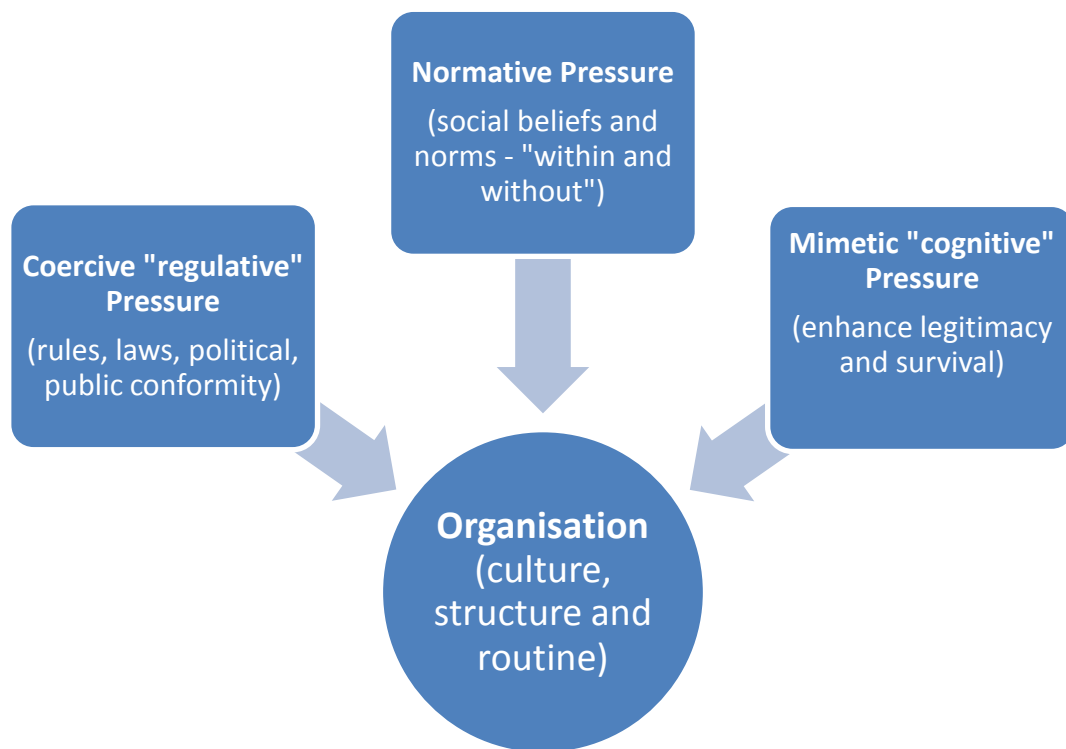
There is also a suggestion by Sahlin-Andersson and Engwall (2002) that political forces play a major role in the exertion of institutional influence. Their research reveals that professional bodies such as consultants, accounting standard setters, and even the media are active in conveying best practice to a particular field (Powell 2008, p. 5). Tsamenyi et al. (2006) discovered that New Institutional Theory was relevant in their case study that examined variations in the accounting and financial information system of Sevillana, a large electricity company operating in Spain. Similar to the investment banking industry's efforts to influence accounting standards relating to Repos (explained in section 8.4) Tsamenyi et al. (2006, p. 409) discovered that "the institutional environment interacted with market forces and intra-organisational power relations to influence the changes in the corporation's accounting and financial information system".

Similarly, Major (2008) used a case study approach in his study of Marconi, a telecommunications corporation operating in Portugal. Marconi was pressured by the pervasive economic and institutional influences to change its management accounting system in response to the liberalisation of the European telecommunications industry.

This thesis uses DiMaggio & Powell's (1983) coercive, mimetic and normative classifications of institutional forces to explain key drivers impacting on decision-making at the firm, industry and regulatory levels of investment banking. Coercive factors involve governmental power and political influence to generate outcomes consistent with the will of the state and political pressure groups. Normative factors emanate from the influence of the profession to conform to the best practice for its field and through the education system used to train the professionals. Mimetic forces act on agents when they succumb to the safety of long accepted practices and choose to mimic others when dealing with decisions in times of uncertainty. The DiMaggio and Powell (1983) framework is explained in greater detail in the following section.

deemed a sale with a concurrent commitment to repurchase the securities by the borrower at an agreed future date at an agreed price.

Figure 8 - New Institutional Theory Framework



Normative Pressures

Normative pressure is an influence to conform to a social practice or norm. Social practice or norms are validated by their common application within a society. They can therefore "refer to what is commonly done - that is, what is normal or to what is commonly approved - that is, what is socially sanctioned" (Zanna 1991, p. 202). Social norms are like social guidelines of behaviour that are followed by a group (Schacter et al. 2011). Normative pressure can therefore exist in a group of members of the same profession. DiMaggio and Powell (1983) define professionalism as an accepted way for members of a profession to behave. Professionalism is considered to be one of those pressures widely considered in determining a proper course of action or moral duty (Boxenbaum & Jonsson 2008; Deephouse & Suchman 2008; Suchman 1995). According to this definition, a profession will have expectations that its members will follow certain behaviours and norms. Therefore, given these expectations, to appear legitimate, the professionals are inclined to demonstrate the same characteristics and traits.

Educational institutions are a source of normative pressure that is transmitted to individuals. The norms are established through education, either through formal courses, professional training, workshops, seminars and through professional trade magazines. Professional networks where ideas are routinely exchanged are also influential in establishing norms (DiMaggio & Powell 1983; Galaskiewicz & Wasserman 1989; Mizuchi & Fein 1999).

Galaskiewicz and Wasserman (1989) suggest that professionals typically work autonomously or in small teams, and are often insulated from coercive pressures. They agree with DiMaggio and Powell (1983) that information relevant to the production of accepted norms is effectively disseminated through professional networks.

Galaskiewicz (1985) proposes that individuals occupying uncertain positions would tend to seek direction about the best course of action from their professional network, and be inclined to create even closer links within their networks. Notwithstanding an individual's unique personality characteristics, as an employee takes similar professional roles with different employers throughout their careers, they carry with them the same skills and world view from one organisation to another (Galaskiewicz & Wasserman 1989). The assimilation of the same view of the world within the organisation may usurp existing traditions and internal rules, hence subjecting the organisation to isomorphic change (DiMaggio & Powell 1983). Conformity can also be compounded by similar human resource departments, common promotion practices and skills level requirements, which all lead to professionals becoming virtually indistinguishable (DiMaggio & Powell 1983).

Normative pressures have an operational impact on organisations. The legitimacy of an organisation is dependent on the credentials and the personal characteristics and experience of its employees who have the ability to move an organisation closer to conforming to an industry or field where standards and conventional wisdom assist in creating clear boundaries and providing standardised conditions that are associated with a particular profession (Milstein et al. 2002).

Mimetic Pressure

DiMaggio and Powell (1983) define mimetic pressure as the pressure on one organisation to mimic another that is deemed to be successful and legitimate. Mimicking behaviour is found when an organisation is faced with a situation where management is uncertain about a particular decision. (Boxenbaum & Jonsson 2008; DiMaggio & Powell 1983; Greenwood et al. 2008; Milstein et al. 2002; Mizuchi & Fein 1999; Slack & Hinings 1994). Not only does this type of isomorphism generate a sense of security for management, it also brings comfort to investors as it creates the perception of a legitimate survival tactic. This organisational imitation is enabled by the examination of the practices employed by associated organisations within the field (Hasse & Krücken 2008).

An advantage of mimicking another organisation is the low cost on human capital (DiMaggio & Powell 1983). Additionally the act of mimicking can bestow respect amongst other industry participants and stakeholders which are critical elements for a successful investment bank (Galaskiewicz & Wasserman 1989). Organisations seek to mimic other organisations of similar size and structure as:

interactions between organizations tend to be localized along a size gradient, because substantial changes in organizational size are accompanied by structural change, shifts in organizational form, and because organizations with different forms require different resources (Haveman 1993, p. 597).

In a fast moving environment where technology and the process of production is quickly superseded, such as in the highly innovative field of investment banking and the future of the business environment is uncertain, organisations are more likely to submit to mimetic pressure. The decade preceding LB's bankruptcy was characterised by many new financial products as investment banks sought new revenue streams by either fulfilling clients' complex needs or generating opportunities for trading profits. Examples of innovative products developed during this period include collateralised debt obligations (CDOs)¹¹; credit default swaps (CDSs)¹² and new structures of securitisation including the securitisation of new asset classes. According to DiMaggio and Powell (1983) submission to mimetic pressure would be greater in times of uncertainty.

Uncertainty is also found when an organisation undertakes a drastic change in strategy. Under these circumstances an organisation may find safety in mimicking the practices of another organisation with a similar strategy (Haveman 1993). Aspects of diversification which may be mimicked may include changing the range of customers, products or services, and the technology employed. Any new direction associated with a diversification strategy involves a degree of uncertainty such as that experienced in a new business and therefore modelling actions on the behaviours and policies of another organisation which is perceived

¹¹ CDOs are financial instruments like bonds which are collateralised by a pool of assets which generate the income stream necessary to service the interest and principal repayments. A common pooled assets include home mortgages or bonds issued by other entities (International Monetary Fund 2003).

¹² A credit default swap is a financial instrument that transfers the credit risk of an asset from one party to another without transferring legal ownership of that asset. The transferor of the credit risk pays the transferee either a periodic and/or an up-front fee in exchange for protection against possible loss suffered if a credit event occurs on the asset until maturity of the asset (Australian Prudential Regulatory Authority 1999, p. 4).

as successful and legitimate in the same strategic area, reduces perceived risks and increases perceptions of success.

Mimetic pressure can also be found between social groups within different organisations in the same industry. Their interactions in either professional or social environments can constitute the conduit for the pressure to be applied. Communication between individuals can result in the transference of a behaviour, idea or style. “The assumption is that actors will first exchange information and then one will persuade the other to give it a try” (Galaskiewicz & Wasserman 1989, p. 456).

Coercive Pressure

Coercive isomorphism occurs when an organisation is subjected to institutional pressure from another organisation or entity on which there is a reliance or dependence to act in a particular way (DiMaggio & Powell 1983; Slack & Hinings 1994). Coercive pressures appear when a more dominant organisation is able to exert force on a more submissive organisation to comply with its wishes in return for legitimacy. The benefits of legitimacy are commonly financial or continued survival. Submission to coercive pressure is described as “conscious obedience to the incorporation of values, norms or institutional requirements” (Oliver 1990, p. 152). It is mostly evident as a consequence of the compliance towards standards, mandates and rules established by professional associations and governments (Hasse & Krücken 2008; Milstein et al. 2002). Whilst government and regulatory authorities are often cited as organisations which exert coercive pressure, any organisation which has the power to impose sanctions for non-compliance to their requests are also able to exert similar pressure (Boxenbaum & Jonsson 2008).

As well as constituting a direct pressure to comply, coercive isomorphism may manifest as a more imperceptible force to those outside the field (DiMaggio & Powell 1983). Compliance is imposed either directly or implicitly and is a means of attracting and retaining resources. An example of subtle coercive isomorphism in action could include the efforts of a bank in encouraging a debtor to restructure a financial position or balance sheet structure in exchange for continuing availability of debt facilities. In summary, coercive pressures can manifest in a variety of modes both directly and indirectly, from laws and regulations, political pressures, and from a variety of institutions (DiMaggio & Powell 1983; Slack & Hinings 1994).

Although mimetic, normative and coercive pressures of New Institutional Theory are helpful in identifying influences on LB, members of the peer group, the regulators, standard setters, and credit rating agencies, it is inadequate to explain some of the culture within LB and the behaviours of certain individuals within the organisation. This thesis finds that some decision-making within the firm was driven internally by an organisational culture shaped by power relations. Therefore it is useful to augment New Institutional Theory with a Theory of

Power to provide a more robust analysis. The following section outlines Clegg's (1989) Theory of Power used throughout this thesis.

3.1.4 A Theory of Power

This thesis incorporates an institutional perspective on the investment banking industry to explain institutional pressures on LB, and the industry. This theoretical lens is supplemented with Clegg's (1989) Theory of Power which examines power within relationships between actors and is helpful in explaining a convergence of influences precipitating the downfall of LB, and the subsequent investment banking crisis. This thesis explores the use of power to influence LB's key management to make certain questionable decisions during the period prior to the firm's collapse. There appeared to be a 'survive at all costs' mentality which was nourished by the values embedded in the organisation.

Power has been analysed from diverse perspectives as befits its divergent nature. The early theories of power were developed by Hobbes (1651) and Machiavelli (1532). Rather than associating power with individuals, Karl Marx located power in social classes and social systems. His tenet was that power is evidenced in relation to a social class's relative station (Marx 1964). Weber's (1993) definition of power differed slightly viewing it as a means of controlling individuals, resources or affairs to ensure an outcome is achieved despite any resistance or obstruction. "Power is a thing that is held, coveted, seized, taken away, lost, or stolen, and it is used in what are essentially, adversarial relationships involving conflict between those with power and those without" (Schoja 2016, p. 4). The focus of overcoming resistance is a cornerstone of Weber's notion of power as he states that: "Power is the chance of a man or a number of men to realize their own will in a social action even against the resistance of others who are participating in the action" (Weber 1978, p. 926). In the following decades the concept of power developed further focusing on the political and social perspectives. Omitting an action or avoiding a decision was similarly considered an exercise of power (Bachrach & Baratz 1963). Subsequently Lukes (1978) expanded this theory by developing a three dimensions model of power. In addition to the first dimension which dealt with actual decision-making and the second dimension which addressed non-decision-making, he introduced a third dimension where institutional power is exercised to socially construct reality. This means that "those who are able to control meaning are thus in a position to render the others powerless, but also that people are not usually aware of this construction of reality" (Vaara et al. 2005, p. 6). This augmentation of the notion of power expanded the concept to include practices, customs, common principles and social structures.

Another strand of literature on power has focused on the discursive elements which give rise to the existence of power in inter-organisational relationships (Ball & Wilson 2000; Brocklehurst 2001; Carter & Jackson 2004; Deetz 1992; Ezzamel et al. 2001; Gowler 1981; Knights & McCabe 1999; Knights & Willmott 1989; Townley 1993). Further, Foucault (1977)

has been influential in his descriptions of disciplinary practices as well as in his concepts of subjugation and subjectification. Clegg (1989) synthesized different conceptions and views of power and presented a 'circuits of power' theory.

This thesis applies New Institutional Theory with the three circuits of power model developed by Clegg (Clegg 1975, 1979; Clegg et al. 1986; Clegg & Dunkerley 1980). The title 'three circuits of power' implies that each circuit is inter-related to produce structures of power and power relationships between actors. Clegg (1989, p. 158) uses his framework to explain "how relations of agency and structure have been constituted discursively, how agency is denied to some and given to others". He also emphasises that power can occur in everyday events and practices: "Power is the apparent order of taken for granted categories of existence as they are fixed and represented in a myriad of discursive forms and practices" (Clegg 1989, pp. 183-4).

A revised approach by Clegg (1989, p. 20) views power as "more or less complex organized agents engaged in more or less organized games". An analysis of power is "neither ethical nor micro-political; above all it is textual, semiotic, and inherent in the very possibility of textuality, meaning and signification in the social world" (Clegg 1994, p. 149). These concepts are consolidated in Clegg's (1989) three circuits of power model where power can be analysed at different levels: the episodic, dispositional; and facilitative (Clegg 1989). The three circuits include: the episodic circuit which at the micro level deals with communications, feelings and conflict; the dispositional circuit which at the macro level deals with socially constructed meanings that inform relations between members; and the facilitative circuit, which also deals at the macro level, but with technology, environmental contingencies, job design and networks. Each circuit operates through conduits known as 'obligatory passage points' which are likened to conduits which allow the conveyance of empowerment or disempowerment (Clegg 1989). These circuits are further explained in the following sections.

Clegg's (1989) framework of power was selected among several theories of power for this thesis given its effectiveness in other similar studies (Cashmore et al. 2014; Lawrence et al. 2011; Lawrence et al. 2012; Lee et al. 2014). Other theories of power which could have been applied include: Lukes 1978; Foucault 1977, 1978; Foucault & Gordon 1980; Foucault et al. 1988. These studies encompass case studies which explore power relationships between actors and explains the processes that occurred to enable change. Clegg's circuits are structures where power is either generated or expunged and the process by which this power or disempowerment is transmitted through 'obligatory passage points' is a key to understanding the process of change. Clegg's (1989) framework of power deals with this transmission process better and more clearly than the other theoretical frameworks dealing with power and is the reason it was selected over the other frameworks for this thesis. Clegg's (1989) circuits of power theory has also been critically evaluated by Boje and Rosile (2001) who

conducted a critical post-modern analysis of the 150 year empowerment-disempowerment debate. They find that Clegg offers a deeper sociological understanding of systematic disempowerment and domination than other theories. This aspect of empowerment and disempowerment is particularly relevant for this thesis given the fluctuations of power between industry participants and regulators which occurred prior to, and during the GFC.

A study of power by Cashmore et al. (2014) is useful as it adopts a case study approach to reveal how the interaction between parties was able to influence the environmental practice in Bangladesh through the use of new knowledge. In the process, the actors' approach to the environment and ways of thinking was affected. Clegg's (1989) circuits of power was used to reveal a "will to power among the international development community, realised through the construction of knowledge" (Cashmore et al. 2014, p. 1).

Lawrence et al. (2012) explore the function of power in achieving strategic change in direction for traditional businesses. The case study uses Clegg's (1989) three circuits of power to explain how three professional service partnerships managed a transition into a contemporary business through an extremely complex transformation process.

Lee et al. (2014) investigate how power facilitates inter-organisational system integration. In particular the authors' focus on Clegg's (1989) episodic circuit and the obligatory passage points were used to differentiate the affects of latent power and that which is exercised on fostering process driven changes. These examples are not meant to represent a comprehensive list of the literature using Clegg (1989), however, they are effective demonstrations of how Clegg's (1989) three circuits of power have been used to explain the process of power and to justify the use of his framework in the thesis.

3.1.5 Clegg's Circuits of Power

In Clegg's (1989) framework, power is transmitted through the three interrelated circuits before generating an outcome. The framework consists of two macro circuits and one micro. The circuits represent a valuable framework to analyse the use of power internally and externally by both the investment banking industry generally and LB. The analysis reveals practices involving discipline and process which result in imbuing power, or alternatively, disempowering at the macro level of the model. Whilst at the micro level, power is exercised in the everyday exercise of a working routine.

The Episodic Circuit

At the micro level, the episodic circuit is "where power is exercised intermittently" (Clegg 1989, p. 187). Power in this circuit resembles the more traditional notion where power depends on resources, whether they are represented by time, wealth, position, commodities, or knowledge. At this level individuals seek to address several interpersonal conflicts. Firstly

individuals may attempt to resolve issues emanating from their feelings which may instigate an exercise of power over another. Secondly, individuals may address communication whether as a recipient or conveyor. The forms of communication may range from assertive to submissive or technical in nature to simplistic and in each case they define a skew in the power relations. Thirdly, individuals may address conflict, whether overt or covert. Finally, power may be expressed as resistance in the everyday interpersonal relationships inherent within an organisational operating environment (Clegg 1989).

The outcomes between individuals at this level can be both negative and positive and will depend on the social relations, and the resources and means available to the agencies. Since "power always involves power over another and thus at least two agencies, episodic power will usually call forth resistance because of the power/knowledge nature of agency" (Clegg 1989, p. 208).

The Dispositional circuit

The dispositional circuit is constituted of rules of practice (at the macro level) and socially constructed meanings that inform relations between members. This circuit is primarily concerned with the formation and continuation of a member's standing within the organisation and the relevant rules to which they are subjected. The relative standing of a member is a function of position within the organisational hierarchy and their access to resources. The capacity of a member will also depend on the rules and policies which give rise to their standing and which require organisational compliance. Meaning is therefore provided to an organisation through these rules and policies which can undergo a process of constant change thereby potentially altering the balance of power within social relations. The social integration such as the communications within an organisation necessary for these rules to be established and changed is highlighted by Clegg as follows: "Rules are fixed and re-fixed, and meanings are stabilized, through social integration" (Clegg 1989, p. 233).

This circuit involves adversarial undercurrents where authority is legitimised. "Rules of practice are at the centre of any stabilization or change of the circuitry. Through them, all traffic must pass" (Clegg 1989, p. 215). Clegg (1989) notes that these rules should not be likened to the static rules of a game instead they are:

far more fragile, ambiguous, unclear, dependent upon interpretation, and subject either to reproduction or transformation depending on the outcome of struggles to keep them the same or to change them this way or that (Clegg 1989, p. 209).

Within this circuit rules of membership and meaning are interpreted and the interpretations themselves are able to be changed (Clegg 1989, p. 215). The power emanating from these rules are transmitted via the obligatory passage points to affect and inform the social relations between individuals in their everyday activities within the episodic circuit (Clegg 1989).

Therefore the episodic circuit shares a dependency on the dispositional circuit in the formation, interpretation and provision of the rules of meaning and membership. These rules flow into the episodic circuit influencing social relations where power is exercised or contested. The resultant impact on the rules is cycled back through the obligatory passage point where they are refixed to re-order the relations of meaning.

The Facilitative Circuit

Finally, the facilitative circuit, also at the macro level, determines an agency's capacity for power through a process of empowerment and disempowerment. This process uses "a system of rewards and punishment constituted through technology, environmental contingencies, job design, and networks, which empower and disempower" (Clegg 1989, p. 233).

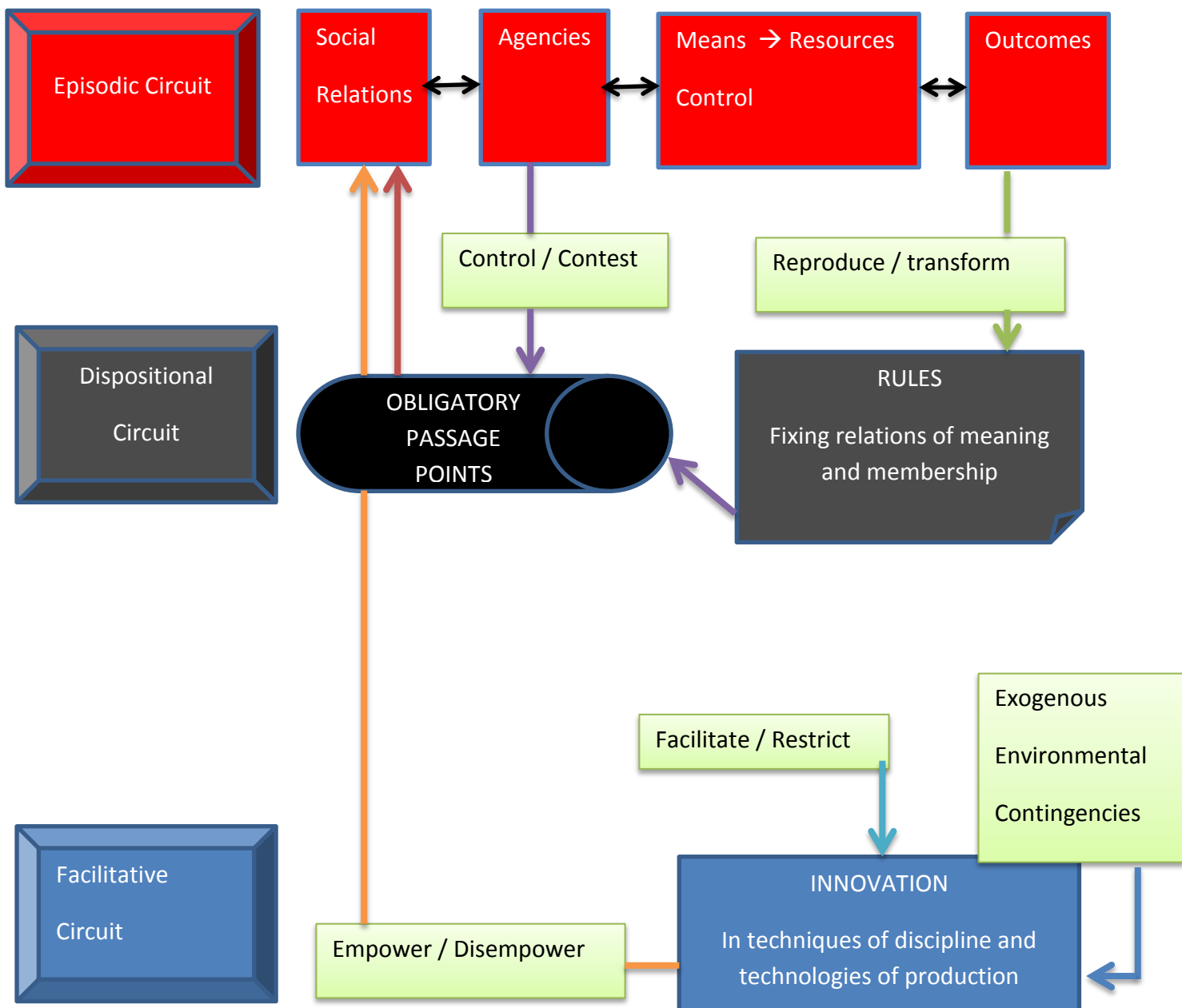
Within the facilitative circuit, Clegg (1989) notes two concepts which can alter the balance of power. These include the 'techniques of production' and the 'modes of discipline' employed by an organisation. Both processes have the capacity to transform existing rules of practice and in turn transfer power between agencies. The facilitative circuit is "a major conduit of variation in the circuits of power" (Clegg 1989, p. 233). An example to describe how innovation can affect power could be the automation of certain manufacturing processes which were previously carried out by skilled workers. The obviated skills disempower those affected employees whilst the employees responsible for the ongoing maintenance of the automated systems become empowered.

The use of job design and networks are useful in applying power both at the regulatory level and through internal relationships within the investment bank. This level of power has the potential to reconstrue organisational morality and transform previously deemed unacceptable behaviour into acceptable behaviour. Apart from investment banking we saw this level of power exerted by Enron during the Californian blackout scandal (McLean & Elkind 2003).

All three circuits of power intersect through a network linked by obligatory passage points. A diagrammatical representation of the three circuits of power is provided in Figure 9. Clegg (1989) uses an example of medical doctors and shop assistants to describe the effect of controlling existing obligatory passage points:

Control of extant obligatory passage points, as by doctors in hospitals, will serve to reproduce institutionally system-transforming change in empowering rather than disempowering ways. For shop assistants, however, who are merely traffic through conduits controlled elsewhere, the impact of 'new technology' is by no means so empowering (Clegg 1989, p. 233).

Figure 9 - Diagram of Clegg's Circuits of Power



Source: (Clegg 1989, p. 214).

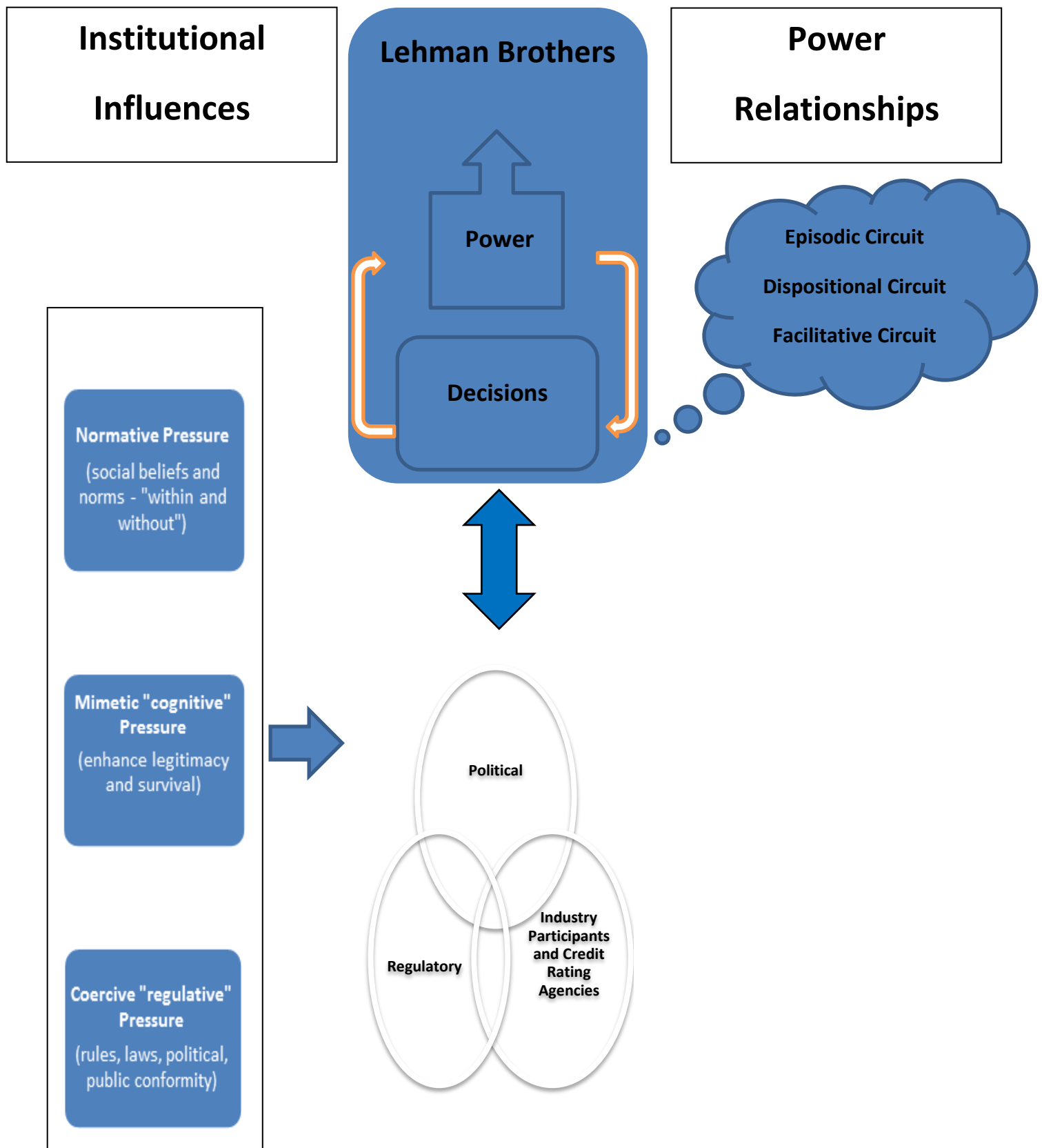
Another example of how the model operates, is located in a study conducted by Crozier (1964). He analysed a tobacco factory which relied on machines maintained by maintenance workers. These machines were controlled by production staff whose bonuses were dependent on the success of the maintenance workers keeping the machines operational. Without the co-operation of the maintenance workers, the ability of the production staff to succeed

in their roles and hence generate bonuses was limited. The highly bureaucratic state-owned tobacco factory's operations were centred on the production staff whose formal standing in the organisational hierarchy was much higher than the maintenance workers. However, the power of the maintenance workers over other staff was superior in view of their control over the production outcomes on which the production staff performance was measured. Management, including the production staff, attempted to resist this power by instituting a program of preventative maintenance. In response, maintenance workers destroyed work manuals and machines were occasionally decommissioned by them regardless of their operational functioning. This example shows how technical knowledge and skill empowered workers who were otherwise low in the formal structural hierarchy of an organisation. Their knowledge of the production process empowered the maintenance workers to overcome the formal power held by others in the organisation (Clegg 1989, p. 236). The maintenance workers effectively possessed a degree of power by way of technical knowledge and skill depicted as the 'technology of production' located in the facilitative circuit of Clegg's (1989) model. The resultant power was transmitted through an obligatory passage point - the process being represented by the destruction of the operational manuals which were instruments vital in management's attempts at diffusing the relative control of the maintenance workers. The resultant effect in the dispositional circuit was to change the significance and meaning of maintenance work. The workers' power in the episodic circuit was also enhanced as their everyday actions involved more control over production resources, pay rates and bonuses. Conversely changes in 'technology of production' can render certain skills redundant, thus disempowering the affected individuals.

This thesis examines similar power relationships evident through the written and non-written interactions of and between the CEO, employees, boards, regulators and key government appointees to help explain their actions as well as inactions in the lead up to the GFC. It will focus on the interactions which had impacted on the failure of LB. It is also a response to Arup (2010, p. 363) who argues the need to "locate power and responsibility in the GFC". While Arup (2010) identifies the potential use of power between state and corporations and suggests that corporate and state power were concentrated together, he contributes little analysis of the mode of power nor the actors' motivations in their use of power.

Therefore with the aid of an analytical lens incorporating New Institutional Theory and Clegg's (1989) three circuits of power model, this thesis explores the individual and institutional machinations, influences, power relationships and pressures which helped shape LB and lead to its final demise. Figure 10 illustrates diagrammatically the combination of the institutional pressures and the internal and external power relationships which influenced an organisational culture which led to the decision-making resulting in LB's demise.

Figure 10 - An Institutional View of Lehman Brothers Impacted by Three Circuits of Power and Institutional Influences



3.2 Methodology

A research methodology is informed by philosophical assumptions relating to ontology “the nature of reality” Dillard (1991, p. 11), epistemology (the means or process of knowing: Dillard (1991, p. 11), human nature (the effect that environment has on human beings: Dillard (1991, p. 11), methodology (the way in which investigation is carried out: Dillard (1991, p. 12) and societal orientation (the inclination of the dynamic forces in society: Dillard (1991, p. 12), (Burrell & Morgan 1979; Chua 1986; Dillard 1991). This study assumes a non-realist ontological stance, that is the culture of investment banking is socially constructed and socially constructing (Chua 1986, Hopwood 1987, Hines 1988). This is contrasted to functionalist approaches. It is argued that regulations covering financial institutions, such as accounting standards, are a socially constructed phenomenon, dependent on people for their existence and use, interpretation and perpetuation. Additionally investment banks that operate within their regulatory framework are reliant on individuals’ decision-making which occurs within a business model that is bound by a set of internal rules and policies which are shaped by an organisational hierarchy and influenced by the regulatory environment and individuals’ capacities. This study emphasises the importance of recognising the social, political and economic contexts to explain the how, why and who of the event (Burrell and Morgan 1979, Chua 1986, Hopwood 1987, Gioia and Pitre 1990, Hassard 1991). This research methodology acknowledges that awareness of the contextual nature of the inquiry is fundamental to this approach (Dillard 1991, Hassard 1991). The methodology applied is consistent with a constructionist case study approach which is a valid research tool used in organisational studies and which is appropriate when using archival data as well as regulatory factors (Baxter & Jack 2008; Yin 2014). Baxter & Jack (2008) argue that methodology which uses a constructivist case study approach provides the means for researchers to investigate ‘complex phenomena’ within their historical context. Yin (2014) supports the view that it is possible to offer analytical generalisations from applying a methodology using a single case study. This can be achieved by a careful application of theory. Consistent with the approach supported by Yin (2014) this study applies a single case study that extracts the presences, as well as the silences, and absences of power, its uses, and institutional influences in and between the various organisations. It also identifies who were the power holders, those subjected to power and how power was exerted.

3.3 Method

The seminal case of LB reflects a particular social phenomenon. LB was a member of a peer group comprising the largest US investment banks which shared a similar business model

and financial structure as explored in CHAPTER 7. Therefore its selection for the case study can inform the behaviours, culture and practices within this sector at this time. Further as LB represented the largest failure amongst US investment banks up to 2008, a case study approach using LB as the subject is considered appropriate. This qualitative study also incorporates some empirical analysis which is helpful in analysing the prevailing business practices and associated communication used by LB and the regulators and in the regulatory documentation itself. Eisenhardt (1989, p. 532) suggests that case studies are useful in informing theoretical development “from specifying research questions to reaching closure”.

A case study approach in the banking field adds to the diversity of the body of literature on the subject. A mixed methods approach was used by Hofstede et al. (1990) for organisations across a variety of industries in measuring organisational cultures. Additionally, similar approaches were conducted to expose the underlying practices and institutions in the accounting profession (Cortese et al. 2010; Mitchell et al. 1994; Mitchell & Sikka 1993; Mitchell et al. 2001). Cortese et al. (2010) analysed comment letters issued by various interest groups to identify otherwise concealed associations amongst powerful agents. (Cortese et al. 2010, p. 76). In this field, interpretive studies are acceptable to analyse the status of the profession, political involvement in the accounting standard setting process, and the relationship between the profession and other government and corporate institutions (Arnold & Sikka 2001; Cousins & Sikka 1993; Mitchell et al. 1998; Sikka & Willmott 1995).

This study analyses the behaviour of participants in the industry, and in particular executives of LB and those parties involved in the political and regulatory environment that are of interest. An organisational case study can offer a deep insight into aspects including the organisation’s history, structure, personnel, personalities, goals, relationships, interactions, resources, context, situation, culture, mission and practices (Atkinson 1995).

This case study includes an examination of certain events, organisations, legislation, regulations and individuals in the history of the industry and the firm to extract recurrent themes to assist in the understanding of some institutionalised behaviours displayed within LB and the investment banking industry in general.

The analysis of certain events, organisations, legislation, regulations and individuals within the case study is overlayed with the applicable theoretical framework, that is, New Institutional Theory and Clegg’s (1989) Theory of Power. This approach draws out structures underpinning the recurring themes. The application of a theoretical lens over historical events, documents and characters is aimed at generating a rich understanding of the cultural and behavioural aspects that led to LB’s failure rather than a mere technical analysis which has permeated the literature relating to the GFC. This method explains rather than predicts events, behaviours and actions of actors which offers insights within the historical and social contexts relevant to the research question.

This thesis uses history not as an ontological realist historian would translate historical evidence to establish a causal relationship. Rather it incorporates history to consider the broader social implications of the events that occurred prior to the GFC. This approach which is supported by Gaffikin (2011), is done with the application of a theoretical lens to provide a rich picture, explanation and point of view in a social and cultural context of the events leading to the resulting social and economic devastation. This thesis adopts the position that “history should be engaged in sustained, mutually questioning and self-questioning interchange with critical theory and historians should read demanding, often difficult theoretical texts and enquire into their bearing for historical enquiry and the very understanding of historiography and historicity” (La Capra 2007, p.161).

Specific data used is described in the table below:

Figure 11 - Data Sources

Data Source	Description
The report of the bankruptcy examiner on the failure of LB.	This report consists of 9 lengthy volumes (refer Figure 12 below) and covers various subjects including, business and risk management, valuations, survival and the discharge of fiduciary duty, Repurchase Agreements 105 (Repo 105) - an accounting ‘window dressing’ technique used by LB, interactions with secured lenders, and LB’s interactions with government agencies. It also contains information from interviews conducted with 250 subjects many of whom were LB employees.
Annual reports, proxy statements and quarterly reports of Lehman Brothers Holdings Inc. from 1999 to 2007.	Financial statements enable analysis of financial data and commentary made by LB executives and directors.
Various financial statements, Proxy statements and official SEC lodged corporate documents published by LB’s investment bank peer group.	These statements contain relevant financial information and commentary to enable industry comparisons between peer group members.
Internal emails and various other LB documents such as a Strategy Presentation, Ethics Statements and Board Committee Charters.	Emails authored by LB executives and the Strategy Presentation were sourced from the Bankruptcy Examiners Report.
US Financial Accounting Standards.	Standards specifically covering repurchase agreements including Statement of Financial Accounting Standard No. 140 (FAS 140) and

Data Source	Description
	Statement of Financial Accounting Standard No. 125 (FAS 125).
Comment letters submitted to the Financial Accounting Standards Board.	Specifically submissions from the banking and finance industry regarding the creation of FAS 125 and FAS 140.
Commercial books and transcripts.	Commercial books some of which have been authored by participants in the investment banking industry, employees of LB and others by regulators.
Media including press articles.	Press articles prior to and after the failure of LB.
Various datasets.	Dataset sources include: Baker Library Lehman Brothers Dealbook Collection, Centre for Responsible Politics, World Bank, Federal Reserve Bank of New York, Federal Reserve Bank of St Louis, Bankscope, Osiris, Compensation Force, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Council on Foreign Relations, Investorpoint Inverstor Information, United States Whitehouse Archives, Securities Industry and Financial Markets Association, US Senate Office of Public Records,

Figure 12 – Contents of the Bankruptcy Examiner’s Report on the failure of Lehman Brothers Holdings Inc. dated 2010

Volume No.	Pages	Content
1	1-193	Introduction, Executive Summary and Procedural Background.
2	203-718	Valuation of portfolios, Survival Strategies and Efforts.
3	732-1053	Repo 105.
4	1066-1535	Potential Claims Against Secured Lenders, Interaction Between Lehman and the Government.
5	1544-2208	Avoidance Actions, Barclays Transactions.
6	Tab 1	Legal Issues

Volume No.	Pages	Content
7	Tab 2 – Tab 7	Glossary, Key Individuals, Witness Interview List, Document Collection and Review, Lehman Systems, Bibliography.
8	Tab 8 – Tab 22	Risk Management Organisation and Control, Risk Appetite and Value at Risk (VaR) Usage Versus Limits Chart, Calculation of Certain Increases in Risk Appetite Limits, Compensation, Valuation – Archstone, Survival Strategies Supplement, Valuation – CDOs, Narrative of 4/9/2008 to 15/9/2008, Valuation – Residential Home Loans, Repo 105, Summary of Lehman Collateral at JP Morgan, Lehman’s Dealings with Bank of America, Knowledge of Senior Lehman Executives Regarding The Inclusion of Clearing Bank Collateral in the Liquidity Pool, Lehman Brothers Holdings International (LBHI) Solvency Analysis, Preferences Against LBHI and Other Lehman Entities.
9	Tab 23 – Tab 34	Journal Entry, Cash Disbursement, and JP Morgan Collateral, Foreign Exchange Transactions, Intercompany Transactions Occurring within 30 days before Bankruptcy, CUSIPs ¹³ with Blank Legal Entity Identifiers, CUSIPs Not Associated with an LBHI Affiliate, CUSIPs Associated Solely with an LBHI Affiliate, CUSIPs Associated with Both Lehman Brothers International (Europe) (LBI) and LBHI Affiliates, CUSIPs Associated with Subordinated Entities, CUSIPs Associated with LBHI Affiliates Not Delivered to LBI in a Financing Trade, Summary Balance Sheets of LBHI Affiliates, Tangible Asset Balance Sheet Variations.

¹³ Committee on Uniform Security Identification Procedures is a code used to identify financial securities issued in the US to enable the settlement of transactions.

Source: (Valukas 2010).

The benefit of using historical events and documents in this case study is to extract themes in the business environment which recur thereby providing insights into management decision-making. This approach is useful in studies based on the experience of the firm (Davis 1971). The compilation of individual historical studies of businesses within an industry has the potential to produce an insightful portrait of the whole industry's history (Davis 1971; Miller & O'Leary 1987). Hidy's (1949) examination of the UK firm Baring Brothers offered an understanding of the investment banking industry; Johnson & Supple's (1967) study of wealthy Bostonians provided insights into the the social and economic world of regional capitalists; and Williamson & Smalley's (1957) case study of Northwestern Life, provided an understanding of the insurance industry.

Instead of focusing on an individual firm, Carosso (1970) used an historical account of the growth of the investment banking industry to gain an understanding of historical economic developments. Although he included a discussion of some practices of the investment banking industry and regulatory developments, a gap in the literature still exists as he failed to explore the consequences or drivers of that regulation, and how it was influenced by outside stakeholders, which is a focus of this thesis.

Carnegie and Napier (2002, p. 711) when discussing studies in accounting development, support the view that "interpretive and critical research, set firmly in the archive as broadly construed and appropriately elucidated by existing or refined theory, may ... present insights into both the present and the future". The historical approach taken generates an alternative attempt as described by Cooper and Puxty (1996, p. 287) as a "political and cultural understanding" of the investment banking industry. The underlying themes of interplay of power, common personal characteristics between actors in the industry and common industry practices explain a cultural identity within LB and is consistent with Gaffikin's (2011, p. 239) contention that historians "... are obliged to consider the broader social implications...".

Gaffikin (2011) supports an historical approach that encompasses a political and cultural understanding. He claims it considers important factors such as "objectivity, fact, evidence (sources), fictive elements, truth, relativity, language, narrative, text, rhetoric, causality, historical laws and many other considerations obviously important to the ... historian. They enable and shape history" (Gaffikin 2011, p. 238). It is the illumination of some of the aforementioned matters that this thesis highlights with a broader theoretical framework which takes into account institutional pressures and the interplay of power relationships.

A case study offers two important opportunities: firstly it allows an analysis of practice; and secondly, it permits an evaluation of the theory used. As mentioned above, this thesis explains the practice within the investment banking industry using the theoretical frameworks of New Institutional Theory and Clegg's (1989) Theory of Power. In the process, these theo-

ries were found to be complementary and useful in offering a critique of the underlying assumptions of agency by examining the existence and processes of power and exertion of influences from internal and external sources to the organisation rather than an uncritical shareholder view of events.

An important role for the methodology used in this thesis is to afford a means of applying a theoretical framework to provide structure to events and behaviours within the industry over a sufficiently long period. The theories have been applied in this thesis in an historical context over a 230 year timeline of the US investment banking industry. They were found useful in explaining the cultural and behavioural influences on the investment banking industry which contributed to the failure of LB.

New Institutional Theory offers limited scope for explaining the impact of personal characteristics found in the investment banking industry. However, Clegg's (1989) Theory of Power is useful in this respect and helps to uncover the pattern of certain behaviours by individuals which are identified in the history chapters 4 and 5. Whereas New Institutional Theory assists in understanding the institutional influences which came to bare on firms from various sources including the the industry's own peer group, regulators, legislators, credit rating agencies and the investment community, Clegg's (1989) Theory of Power deals adequately with the power relations between individual actors.

In summary, this chapter outlined the two theoretical frameworks applied in the thesis. It argued that other theories were inadequate in explaining all the forces at play in the investment banking industry up to 2008 and claims that by augmenting New Institutional Theory with Clegg's (1989) Theory of Power a richer understanding of the causes of LB's failure is achieved. The constructivist methodology using a case study approach is introduced as an appropriate tool in answering the research question which in turn offers insights into the causes of the GFC. The following chapter, provides an understanding of the cultural evolution of the investment banking industry by presenting various key personalities and events throughout its history in the US. The analysis of the practices within the investment banking industry in and around certain historical events such as economic crises offer an understanding of the influences exerted on the regulatory field and the opportunities and challenges confronting the investment banking industry throughout this period. Ultimately the historical influences help explain the behaviour of industry participants to the present day and in turn the resultant analysis helps to elucidate the theories used.

CHAPTER 4 **HISTORICAL INFLUENCES ON THE US INVESTMENT BANKING INDUSTRY**

According to Morrison and Wilhelm (2007) the evolution of the US investment banking industry is better understood through a chronological analysis of the key events occurring in the US which may have affected the industry. In the process it is possible to understand the industry in its societal context. This chapter will outline the history of the investment banking industry through an analysis of the critical events which occurred in the US since the industry's early beginnings and through the personalities who pioneered and imparted their influence within their own firms to the industry and to the wider financial community. The chapter draws together some important themes repeated throughout the history of the industry in relation to behavioural characteristics of the players and the organisational culture within the industry which had been influenced by DiMaggio & Powell's (1983) institutional pressures and in which the exercise of power as described by Clegg (1989) was evident. The history section also provides context for the later chapter dealing with LB's own history (refer CHAPTER 5) and enables a comparison between the pervasive organisational culture existing within the industry and the culture which evolved within LB. The chapter illustrates that LB's culture and behavioural practices were shaped by similar influences acting upon the industry at large.

The historical tracing of investment bank activity in the US is not only a search for formally structured business entities whose operations we associate with modern investment banks, but also includes the commercial undertakings of individuals usually relating to commercial fund raising or advisory services. The US investment banking industry had humble beginnings and emerged parallel with the formation of the US, following the American War of Independence 1775 - 1783. Most commercial funding up until this point was carried out by small private banks or merchants, primarily for funding trade and other commerce. Many of these private banks developed into investment banks in the period following the American War of Independence (Bass & Moulton 1921). The transformation of entities into investment banks progressed along two major routes. One involved the transformation of currency broking firms such as Prime, Ward and King and, John E. Thayer and Brother, which carried out private banking as well as some investment banking activities. The other route involved merchants expanding their business to incorporate lending activities, followed by trading in commodities such as cotton. These firms included Lehman Brothers, Thomas Bidle and Co. and Alexander Brothers (Werner & Smith 1991).

Currency exchange dealers were necessary in the colonies as there were numerous currencies in circulation. By the late 1700s, there existed over fifty currencies in the US including

offshore currency imported from Britain, Spain, France, Portugal, and notes issued by a variety of entities such as state and municipal governments, and private businesses. Valuation of these currencies was carried out by the various brokers and since communication was inefficient, exchange rates varied widely between brokers and regions. The publication of exchange rates in the 1790s improved the consistency of currency quotations (Weiss 1970). This money was used by merchants in their domestic and international trade and for settling other transactions between citizens and government authorities. The exchange value for each currency was a difficult task to ascertain given the different values ascribed to a currency by different states and the expertise offered by the currency exchange dealers was important (Weiss 1970).

The expansion of the financial sector in the 1800s provided opportunities for entrepreneurs to raise the necessary finance to undertake projects which accompanied the significant US industrial expansion of the period. The early private and commercial bankers often relied on their personal relationships with established entrepreneurs to facilitate their credit assessment process. Consequently their inside information on projects enabled the industry to maintain relatively low levels of problem loans and the period was characterised by very few bank failures (Moulton 1921). The exploitation of personal relationships is noted by Moulton (1921) as a means to improve an understanding of credit risk and expand business activities and becomes a consistent theme within the US investment banking industry throughout its history. This common practice of exploiting personal relationships relates elements of DiMaggio & Powell's (1983) normative and mimetic pressures. The normative pressure established the practice as an acceptable way for a banker to behave and therefore established a social norm amongst the investment banking community. After-all the practice indirectly led to protecting the firms against loss by providing deeper insights into the credit risk of borrows or to share the related risks amongst a peer group known as a syndicate, on the one hand, and potentially increasing revenues by the generation of additional business from either existing or new clients on the other. As the primary goal of investment banks is to maximise profits for its partners and stockholders, both tactics would assist this objective. The mimetic pressure applies as bankers feared that by not imitating successful strategies adopted by other industry participants to maximise profits, they would suffer a competitive disadvantage, and would risk losing market share and consequently potential profits to other banks.

Mercantile firms largely dealt with international trading transactions, facilitating payments for goods by providing short term credit to shippers. US mercantile firms often undertook their activities by using agents in the overseas country where the trade had been carried out. This contrasted to the British practice of using a network of branches. Not only was the mercantile firm a precursor to the US investment bank but it was from these firms that many of that British merchant banks emerged (Cameron & Bovykin 1991).

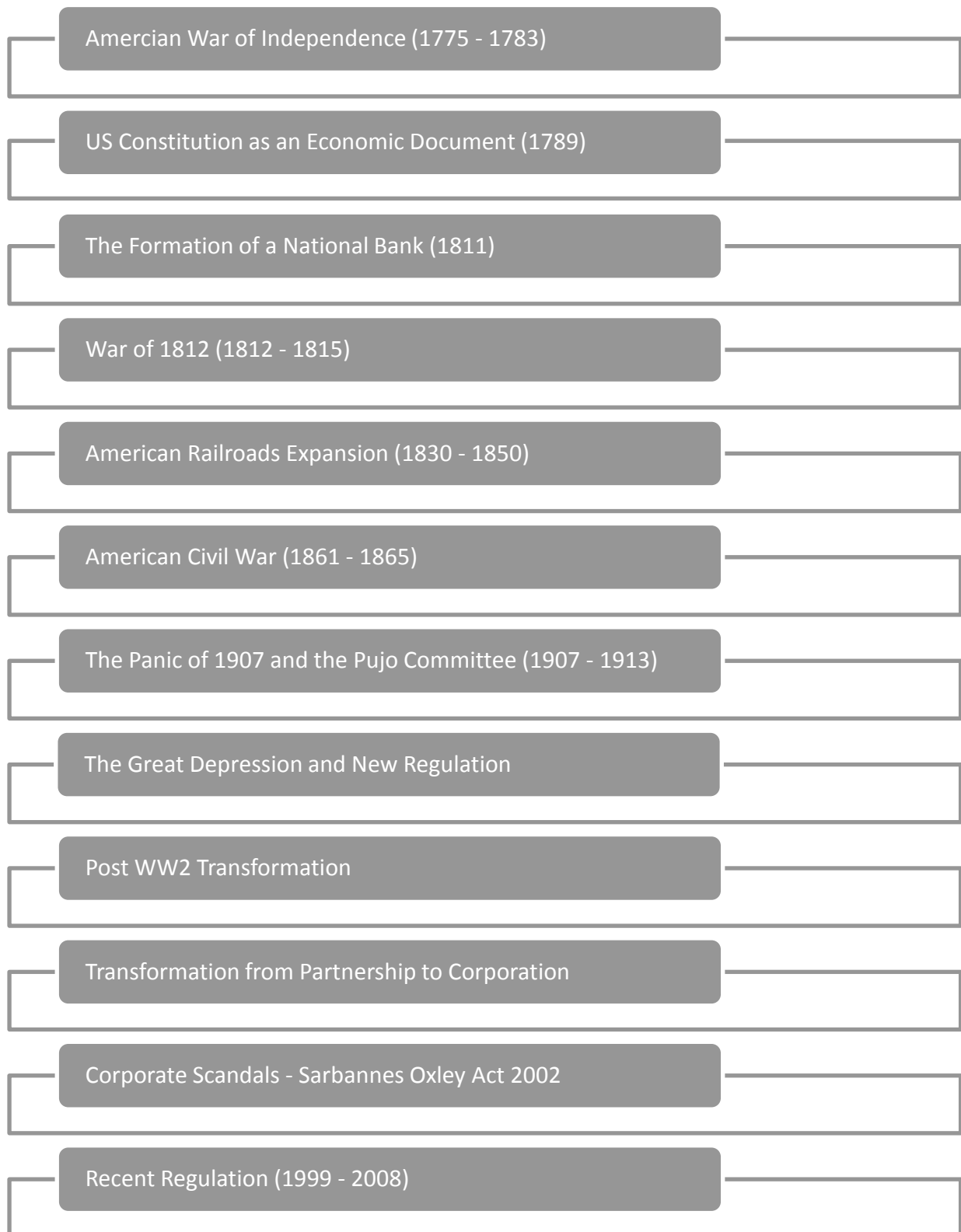
The following sections reveal how certain characteristics and business strategies of a modern day investment banks found their origin as far back in history as the American Revolution. The selected historical analysis will be chronological for ease of understanding the evolutionary influences. The recurring overriding theme of power and its role in the interactions between investment bankers and government authorities and with other organisations and institutions will also be developed in this historical analysis. Three subsidiary themes which are related to the theme of power and influence are developed:

- 1) Relationships with government authorities and officials;
- 2) Influence through networks; and
- 3) Personal characteristics and culture.

4.1 Timeline of Events Shaping the Investment Banking Industry

The timeline below highlights periods in the history of the US investment banking industry which are shown to be formative and influential. An effective way of illustrating the themes in some of the periods is through an understanding of the background, business activities and modus operandi of individuals involved in the industry. This method, for example, is particularly relevant for the period covering the Revolution and subsequent years in the early history of the US when investment banking activities were starting and were predominantly carried out by individual entrepreneurs.

Figure 13 - Evolution of the US Investment Banking Industry



The timeline above is characterised by major events or periods of time which prompted changes or highlighted features of the US investment banking industry. Periods not covered by the timeline are generally characterised by stable economic growth following the birth of the industrial revolution circa 1780 (Reinhart & Rogoff 2009). During this era, the investment banking industry generally prospered with the exception of times of banking crises. It was natural for investment banks to experience similar difficulties as commercial banks during the banking crises. As an emerging economy, the US was susceptible to volatile economic cycles and financial market disruptions. A disproportionately high number of financial crises occurred in the 1800s during which the US experienced eight major panics whilst from 1900 to 2008, the US experienced three major crises. Financial crises can be identified in the following years: 1814, 1819, 1837, 1839, 1857, 1873, 1884, 1893, 1896, 1907, 1929, 1987 and 2008. Financial crises most often precede a banking crisis typified by a systemic failure of banks. From the financial crises the major banking crises¹⁴ occurred in 1857, 1873, 1893, 1907, 1929 and 2008 (Reinhart & Rogoff 2013).

The evolution of the investment banking industry was punctuated by the US banking crises during the 19th and 20th centuries. Most banking crises naturally coincide with the troughs of economic cycles. The GFC was similar to many of the previous crises. Like other crises it was preceded by speculative bubbles in certain asset classes which culminated in a crash, often involving the stock market and ultimately resulting in a recession (Reinhart & Rogoff 2009). As most investment banks are traditionally active in the capital markets, both debt and equity, stock market crashes inevitably negatively affected their operations. This can be seen in the table below which sets out significant US banking crises during this period. Reinhart and Rogoff (2009) cite inadequate regulation as a customary contributor to a financial crisis. Whether or not inadequate regulation contributed to the GFC will be examined in this thesis. When the US was not in crisis, economic growth and industrialisation kept investment banking firms occupied and profitable, thereby removing incentive for change. As a result, successful practices and behaviours which prevailed in the late 1700s continued through to the modern day. Apart from financial crises and periodic regulatory reform the evolutionary timeline was punctuated in the post WW2 era by the search for

¹⁴ A major banking crisis here is defined as one where economic growth has declined by over 10% in a peak to trough of an economic cycle. This differs from other definitions of a banking crisis which often cite a number of bank failures as a measure constituting a banking crisis.

capital which carried far reaching implications for the investment banking business model and financial structure, discussed in detail in section 4.4. The following table is a reconstituted excerpt from Reinhart and Rogoff (2013) and outlines a brief history of banking crises in the US:

Figure 14 - US Banking Crises: Historical Summary

Year	Brief Summary	Reference
1814	Johnson Matthey Bankers failure.	Conant 1915; Reinhart & Rogoff 2013
1817-1819	46 banks rendered insolvent due to demands for specie by Second Bank of the United States.	Conant 1915; Reinhart & Rogoff 2013
1825	Preceded England's crisis; Bank of the United States and all other banks brought to the verge of suspension.	Conant 1915; Reinhart & Rogoff 2013
1837-1838	Three banks failed (March 1837); Bank of England gave generous advances to other banks to prevent panic; failures began in New Orleans and New York City and spread to other cities' banks.	Conant 1915; Reinhart & Rogoff 2013
1841	Second Bank of the United States liquidated; lenders repaid but stockholders lost all interests. Twenty six banks failed.	Conant 1915; Reinhart & Rogoff 2013
1857	Discovery of Australian and Californian gold fields led to massive speculation on various commodities and property and then collapse; paralysed finances throughout the world (spread from US to Europe, South America and Far East). Many banks suspended; The Bank of England the only source of discount/financing.	Conant 1915; Reinhart & Rogoff 2013
1861	Government suspended specie payments – lasted until 1879; drove up price of gold (peaked in 1864) and all other retail items.	Conant 1915; Reinhart & Rogoff 2013
1864	US panic due to Civil War.	Conant 1915; Reinhart & Rogoff 2013
1873	Philadelphian banking firm, Jay Cooke & Co. failed, triggering a recession that lasted until 1877.	Conant 1915; Reinhart & Rogoff 2013
1884	Weak commodity prices and a series of brokerage firm failures led to bank runs and suspended payments, mostly in the New York region. The output effects were mild.	Bordo & Eichen- green 1999; Conant 1915; Reinhart & Rogoff 2013
1893	Monetary uncertainty and stock market crash led to	Bordo & Eichen-

Year	Brief Summary	Reference
	bank runs. Political action to ameliorate the crisis; severe decline in output but the economy recovered quickly.	green 1999; Conant 1915; Reinhart & Rogoff 2013
1907	Global credit restrictions and domestic financial excesses, increasing number of state banks, and a rising ratio of deposits to cash reserves set the stage for a crisis. Real estate and stock market speculation burst; crisis spread from New York nationwide. Growth rate fell by 9% per annum. JP Morgan, the Bank of Montreal and the Treasury of New York replenished liquidity.	Bordo & Eichen-green 1999; Conant 1915; Reinhart & Rogoff 2013
1914	New York Stock Exchange closed until December in response to World War 1; however a banking crisis was avoided by flooding the country with emergency currency to prevent hasty withdrawals.	
1929-1923	Great Depression: thousands of banks closed; Bank of USA failed in December 1930; between August 1931 and January 1932, 1,860 banks failed.	Bernanke & James 1991; Bordo et al. 2001; Reinhart & Rogoff 2013
1984-1991	1,400 savings and loans institutions and 1,300 banks failed.	Bordo et al. 2001; Reinhart & Rogoff 2013

Source: (Reinhart & Rogoff 2013, pp. 17-8).

4.2 Selected Personalities and Events Influencing the Industry

4.2.1 American War of Independence (1775 to 1783)

The American War of Independence, also known as ‘the Revolution’, ‘the American Revolution’ and ‘the American Revolutionary War’ is used as a starting point for this thesis in tracing the beginnings of the US investment banking industry. It is deemed appropriate on two fronts. Firstly it symbolises the birth of a modern nation which was to become the United States of America; and secondly it symbolises a struggle for independence from Great Britain both politically and economically. This war resulted in funding needs which gave rise to a class of financier that would morph into the investment bank with which we are now familiar.

The Revolution began when thirteen British colonies in North America sought independence from Great Britain. It concluded with the Treaty of Paris, which recognised the sovereignty of the US. The Americans entered the war with many disadvantages compared to the British. They had no national government; no national army or navy; no financial system; no domestic banks; no established credit; and no functioning government departments such as a treasury department (Shy 1976). It is against this background that the seeds of the modern investment banking industry were laid.

The Revolution was costly on several fronts for the Americans. Not only did it cost the lives of over 25,000 American Revolutionaries (Shy 1976), but it had cost the new nation, the equivalent in USD terms at the time, USD 37 million at the national level plus USD 114 million by the states (Jensen 2004). This cost was mostly covered by loans from France and the Netherlands, who had participated in the war in support of the Americans. Also they, together with Spain, provided supplies such as guns, ammunition, clothes and blankets. Much of the funding for this equipment was sourced domestically within the US by loans from the American public and through the issuance of paper money known as ‘specie’ including both continental and state currency (Baack 2001).

The British attempted to sabotage the economy of the American colonies and thus weaken the Continental Congress¹⁵ by counterfeiting the Continental dollar and flooding the local market with the currency. The resultant increase in money supply impacted on the inflation rate, and a depreciation of the currency leading to an increase in costs for everyday goods including supplies for the continental army. This event gave rise to the saying of 'not worth a Continental' (Baack 2001, pp. 643-4). By the end of 1777 inflation had depreciated the value of the Continental dollar by over 70%. This rapid devaluation of the Continental dollar posed significant financing issues for the Continental Congress, since up to 1777, currency emissions accounted for almost 90% of Congress revenue which had by then declined to 19% (Baack 2001, p. 643). It was clear that for the Continental Congress to continue to fight the war it needed to secure alternative sources of finance other than printing currency. This allowed some entrepreneurial individuals with the opportunity to enter into relationships with the Continental Congress and its officials to support the required financing effort. An assessment of the role played by financier, Haym Salomon in the following section provides an example of how key relationships were used for financial gain. This is a recurrent theme appearing throughout this chapter and will be analysed further with other examples of key historical figures.

4.2.2 Haym Salomon (1740-1785) Financier to Government

Figure 15 - Portrait of Haym Salomon



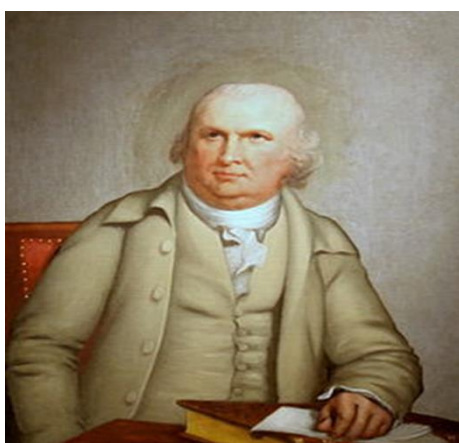
Source: (Historic.us 2015).

¹⁵ The Continental Congress comprised a convention of delegates selected as representatives from the thirteen American Colonies which were under British rule. The Continental Congress replaced the British as the governing body of the US during the American Revolution (Encyclopedia.com 1997).

Haym Salomon was one of the earliest individuals whose activities typically resembled that of an investment banker given his role in assisting the financing of the Revolution (Feldberg 2001). Salomon, born into a Jewish family in 1740, emigrated from Poland to New York city in 1772. Salomon, who through his travels around Europe learned several languages including German, was operating as a merchant, foreign securities dealer and financial broker in New York City. After becoming friends with Alexander MacDougall, leader of the New York Sons of Liberty, he was attracted to the colonial cause for independence. His patriot activities became known to the British and in 1776 he was arrested as a spy. The British released him on the basis that he co-operated as an interpreter assisting the British with their German allies (Feldberg 2001). Salomon's loyalty remained with the patriots and he continued to offer support by assisting patriot prisoners to escape British imprisonment and German soldiers to desert. He was again arrested in 1778, however escaped and finally settled in Philadelphia, where he resumed his investment banking activities. He continued to assist the patriots by serving their French allies as paymaster and as a financial consultant to the French consul (Blythe 2008).

Whilst Salomon was in Philadelphia, the Continental Congress had been relatively unsuccessful in raising the necessary funds to finance the war effort. Most funding was met by the issuing of currency with small amounts coming from the states which were similarly struggling. Without a formal federation in place, the Continental Congress did not have a mandate to raise funds from taxation and therefore decided to augment its finances by borrowing from the French and Dutch governments. By 1781, Congress was struggling to manage its financial commitments and assigned Robert Morris a member of the Second Congress, to the position of Superintendent of Finances (Blythe 2008).

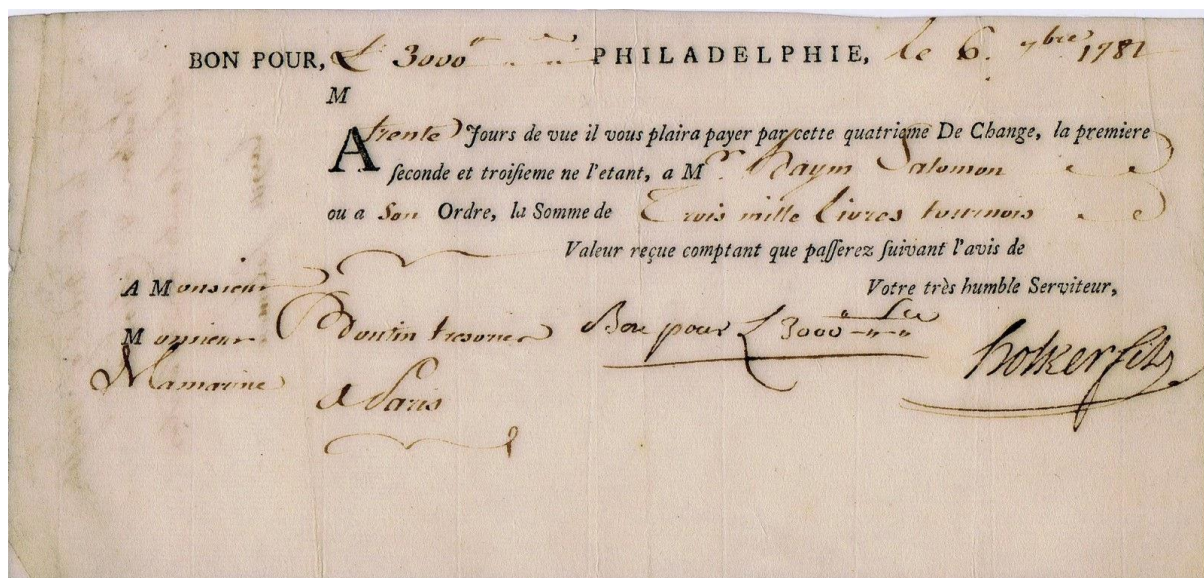
Figure 16 – Portrait of Robert Morris – A Superintendent of Finance with Good Connections



Source: (Pine c.1785).

Morris established the First Bank of North America also known as the Bank of North America and provided much needed finance for the patriots' war effort (Blythe 2008). Salomon continued to support the patriots' war effort by acting as a broker for bills of exchange, which were instruments drawn to raise funds for Congress. He also provided personal loans to members of Congress, on an interest free basis. One of the recipients of these favourably termed loans included James Madison, who later became the fourth president of the US (Blythe 2008). This is one of the earliest examples of a private financier providing assistance to members of government whilst also providing assistance to the government itself. One of the principal roles of Salomon as the official broker to the Continental Congress was to exchange the foreign currencies arriving from Europe, representing the proceeds from the French and Dutch loans, into Continental dollars. The most common type of currency conversion emanated from the remittance of bills from the French government in French currency.

Figure 17 - Bill drawn by French Government in 1781 to Bearer or Shaym Salomon



Source: (Salomon 1781).

Figure 17, above shows an example of a typical bill remitted by the French government and payable to the bearer who was Haym Salomon. The fact that the bills included Salomon as a payee reflected Salomon's high degree of integrity which was recognised by Robert Morris who oversaw the funding effort and Congress in general. Salomon earned the trust of the Continental Congress which was the ultimate debtor in these transactions and he was also trusted by the French and Dutch governments, the signatories upon which the various bills were drawn and which were shipped to Salomon in the US as the broker of the bills. A partial translation of the face of the bill in Figure 17, reads that the amount of 3000 livre¹⁶ is to be paid to Haym Salomon or to his order, within 30 days of presentation of the bill.

The transactions simply operated as borrowings by the Continental Congress, with the funds sourced from financial instruments issued by France and Holland. These European countries would ship bills drawn by their governments to Salomon who acted as broker. Salomon would sell the bills to the public, usually wealthy merchants, in exchange for Continental dollars and passed on the currency proceeds to the Continental Congress to be used for the war effort. Upon maturity, the bills were redeemed by the bearers (the public) who would be reimbursed for their original investment directly by Salomon as the representative of the French and Dutch governments. The proceeds used by Salomon to reimburse investors would be simultaneously paid to Salomon by the Continental Congress as a repayment of their original loan. To attract investors in the bills, Salomon advertised his service as a broker through newspapers. In return for the sales of bills, mostly to merchants, Salomon received a commission of 0.25% on the bills' face value (Peters 1911, p. 16).

¹⁶ The livre was the currency of France from 781 to 1795.

Figure 18 - Advertisement in 'The Pennsylvania Journal and Weekly Advertiser' 1782

Enquire as above,
Philadelphia, December 3, 1782.

Haym Salomons,

BROKER to the Office of Finance, to the Consul General of France, and to the Treasurer of the French army, at his Office in Front-Street, between Market and Arch Streets buys and sells on commission

BANK Stock, Bills of Exchange

on France, Spain, Holland, and other parts of Europe, the West Indies, and inland bills, at the usual commissions. — He buys and sells

Loan Office certificates, Continental and State Money, of this or any other State, Pay-Master and Quarter-Master General's notes; these and every other kind of paper transactions (bills of exchange excepted) he will charge his employers no more than

ONE HALF PER CENT on his Commission.

He procures Money on Loan for
a short time, and gets notes and bills discounted.
Gentlemen and other, residing in this State, or any of the United States, by sending their orders to this office may depend on having their business transacted with as much fidelity and expedition as if they were themselves present.
He receives, Tobacco, Sugar, Tea, and every other sort of goods, to sell on commission, for which purpose he has provided proper stores.

He flatters himself his assiduity,
punctuality, and extensive connections in his business, as a Broker, is well established in various parts of Europe, and in the United States in particular.
All persons who shall please to favour him with their business, may depend upon his utmost exertion for their interest, and

Part of the Money advanced, if required.

Source: (The Pennsylvania Journal and Weekly Advertiser 1782).

Salomon's Power

The advertisement above Figure 18 describes Haym Salomon as a well-connected broker and financier. Apart from espousing his role as broker to eminent offices in The US and France he assures customers that they “may depend on having their business transacted with as much fidelity and expedition as if they were themselves present” (The Pennsylvania Journal and Weekly Advertiser 1783). Further, his advertisement noted that “he flatters himself his assiduity, punctuality, and extensive connections in his business, as a Broker, is well established in various parts of Europe and in the US in particular” (The Pennsylvania Journal and Weekly Advertiser 1783). This self-promotion of the individual combined with a self-confidence intended to assure potential customers is characteristic of similar investment banking advertisements appearing in newspapers and magazines in the 20th and 21st centuries. Salomon further emphasised the attribute of his ‘connections’ as one which is

beneficial to customers and his business - the business of investment banking. It could therefore be argued that the important feature of being well connected has been a common attribute necessary to succeed in investment banking from as early as the 1780s. Salomon's view of himself was also shared by Alexander Hamilton, a former Secretary of the Treasury:

Haym Salomon brought not only all his wealth to the aid of his adopted country, but a financial insight which, for clearness and depth, was not surpassed by Alexander Hamilton nor equalled by Robert Morris. America found in Haym Salomon a champion equalled by few, his fertility in resource and soundness of financial views made him, through Robert Morris, Superintendent of Finance, the real financier of the Revolution and judged by Alexander Hamilton's standard of patriotism, surpassed by none... (Peters 1911, p. 16).

What was expected in return for Salomon's generous assistance to the Continental Congress and selected congressmen is subject to conjecture however it is not unreasonable to assume that the generally accommodating nature of the relationships with those in positions of power and authority could have been intentionally developed to secure commercial favour. In any event, Salomon exercised a power sourced from what Clegg (1989) described as facilitative and dispositional circuits. Given his relatively unique knowledge of finance, as attested by Alexander Hamilton and advantageous distribution network for the sale of bills of exchange, Salomon possessed a competitive advantage over other financiers in the US at the time. The unique 'technology of production', that is, an ability to use his skills and know-how to broker bills of exchange necessary to secure the required finance for the Continental Congress, rendered Salomon almost indispensable for the war funding effort. Without the prevailing exogenous environment of the Revolution, Salomon's position of influence may not have materialised. An exogenous environment provides the context and stimulus for the empowerment in a facilitative circuit (Clegg 1989). The finances of the Continental Congress were in chaos in 1781, and innovative and urgent solutions were required. Salomon was able to fulfil this requirement and his financial techniques, generous financial support of the patriot cause and role in transacting bills of exchange issued by the French government and their subsequent currency conversions, were all actions that facilitated the transmission of power to the episodic circuit where agencies with external parties such as Morris intervened to assist in generating the desired outcome. The resultant social relations developed by Salomon with Morris and other congressmen enabled his appointment as the official financier of the government which led to two outcomes: firstly, a financial solution for Congress and secondly, further business transactions which were commercially favourable to Salomon.

The relative control over the fundraising activities of Congress provided Salomon a special standing within government, which was ratified and perpetuated by Morris in his official capacity as Superintendent of Finances. This special status within government, formed within the dispositional circuit, reinforced Salomon's power which he continued to exercise in his social interactions with various members of Congress.

The Early Formation of Mimetic Influence

The development of Salomon's power described in the previous section originated from a combination of his unique skills and know-how, superior ability to distribute financial instruments and special relations developed with key individuals who could offer new and additional business for commercial benefit. These attributes, sanctioned by the leading authority in the land, the Continental Congress, represented acceptable professional skills in the wider financial markets industry. Given the industry's technical sophistication, many outside groups such as politicians, other professionals and the public at large were relatively unfamiliar with the prevailing *modus operandi* of the industry. Therefore due to this widespread unfamiliarity with investment banking skills, the practices and behaviours of individual investment bankers remained unchallenged and were considered to be acceptable within a social context.

One of the key practices emulated by others was the tactic of soliciting relationships with politicians in exchange for favours. These favours would inevitably include privileged treatment in selection for government fundraising. Often these financings would be transacted on favourable terms to the investment banker. Salomon's other business activities and practices were also emulated by other firms as they represented profitable enterprise and were accepted by the general commercial, political and public communities. This replication of business practice is a form of DiMaggio & Powell's (1983) mimetic isomorphism as described in section 3.1. Other investment bankers soon entered the business of broking financial instruments such as bills of exchange and foreign exchange trading until these lines of business became commonplace. The business of broking contributed significant profits to many investment banks as it does in the modern era and constituted a major source of revenue for LB. Moreover the practice of developing special relationships with parties that could offer commercial benefit became accepted, even if it involved personal favours for government officials. This public acquiescence to the behaviour of the investment banking industry was to last until the early 20th century when the investigations of the Pujo Committee commenced. See section 4.2.19 for a discussion on the Pujo Committee.

As is shown in the remainder of this chapter, the acceptability and even admiration of Salomon's behaviour and practice, including that of other prominent investment banking figures who followed, defined a professional custom within the field and was acknowledged by the wider community. The mimetic influence established a practice which was to be adopted by the industry in future years as a formula for continuing success in business.

4.2.3 The War of 1812

Similar to the Revolution, the War of 1812, presented opportunities for some firms and individuals to support the American cause by assisting in the war funding effort. A background

to the US funding requirements and solutions is presented in this section. Firstly, a brief overview of the war and its costs highlights the dire situation of the government. This is followed by an examination of how Albert Gallatin, the Secretary of the Treasury resorted to a group of innovative investment bankers to solve the problematic funding of the US government deficit.

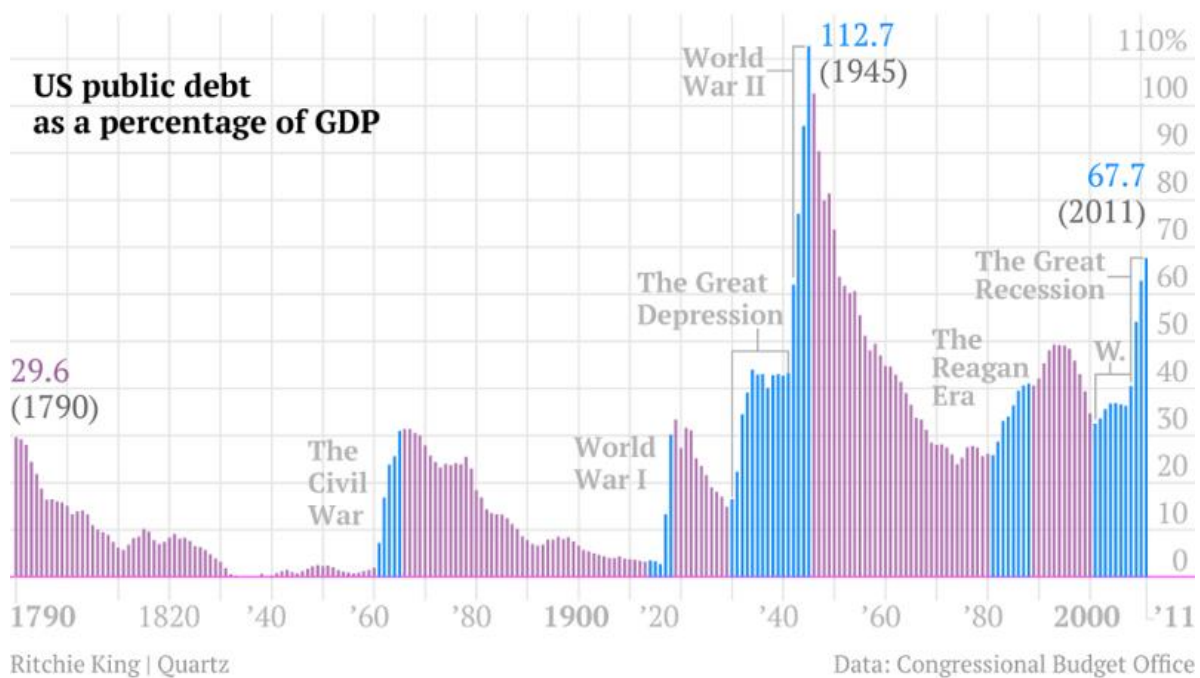
In 1812 the US government declared war on Britain due to a number of factors relating to oppressive behaviour by Britain over the US. Britain had forcefully recruited US citizens into its navy to help in the war against France. The French war had also caused a restriction on trade with the US which had detrimental effects on the US economy. These factors in addition to the British support for American indigenous tribes in their resistance against the American territorial encroachment had brought the US to the point of war (Hickey 1989).

Following the conclusion of the French war, Britain resumed trade with the US and ceased its forceful recruitment of US sailors (Black 2002). This development had appeased the US government, resulting in the end of the war of 1812, which was sealed with the signing of the Treaty of Ghent on December 24, 1814. An unintended consequence of the war was a new nationalistic pride in the north American continent which “concluded almost a quarter of a century of troubled diplomacy and partisan politics and ushered in the era of good feelings” (Black 2002, p. 3). The period following the war of 1812, was also characterised by a productive and peaceable relationship between Britain and the US (Heidler & Heidler 2004).

Cost of the War

Estimates of the cost to Britain of the war of 1812 are unavailable however British government debts had increased by GBP 25 million during the war (Hickey 1989). In the US, the cost of the war totalled “USD 158 million which included USD 93 million in army and navy expenditures, USD 16 million in interest on war loans, and USD 49 million in war veterans benefits” (Hickey 1989, p. 306). This resulted in the national debt increasing from USD 45 million in 1812 to USD 127 million by the end of 1815, implying a net borrowing of USD 82 million by the end of the war (Hickey 1989, p. 233). The following graph of public debt as a percentage of GDP from 1790 to 1865 sourced from data from the Congressional Budget Office shows debt to GDP for the US increasing significantly from 1810 to 1815 encompassing the period of the war Figure 19.

Figure 19 - US Public Debt as % of GDP - 1790 to 1865



Source: (Phillips 2012).

Sources of income for the government were scarce. The government had not yet instituted an income tax regime, and other taxes were inadequate. Apart from selling bonds, which will be described later in this section, the government resorted to raising funds through lotteries. A number of private organisations and institutions participated in the selling of lottery tickets including S & M Allen & Co. which was established in 1808 to sell the new lottery tickets (Geisst 2001, p. 11). S & M Allen & Co. was typical of businesses that developed skills tangential to those required for an investment bank. Selling lottery tickets from their network of twenty offices generated only meagre profits however. The firm quickly realised that greater profits could be earned from selling securities through the same network. There was little difference between the two activities and by 1820 the firm switched from selling lottery tickets to exclusively selling securities. Unfortunately after twenty eight years of successful operations, S & M Allen & Co. was forced to close its doors in 1836, not from a failure of their business model but following a series of losses following the collapse of the Second Bank of the United States which contributed to the financial crisis of 1837 (Geisst 2001, p. 12).

Replication of Distribution Networks – A Mimetic Influence

The key asset of S & M Allen & Co was the vital twenty strong office distribution network along the east coast of the US which connected the firm to its ultimate customer base and

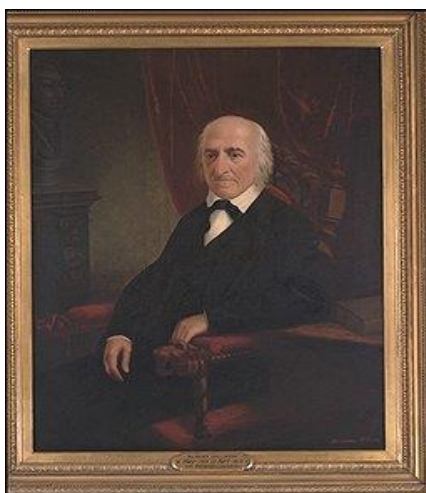
enabled settlement of transactions. To this day distribution power is considered one of the most important attributes of a successful modern day investment bank. The benefits of a large and effective distribution network in selling financial instruments, whether lottery tickets or other forms of securities accrue through the ability to reach a higher number of ultimate investors and thereby increase sales and profits. As other firms realised these benefits they too organised themselves with similar distribution networks and an effective business model dealing with selling securities was given new impetus and remains a strong business segment for investment banks to the present day. The imitation of this business model is an example of DiMaggio & Powell's (1983) mimetic pressure where firms copy other firms which they consider successful.

The overriding driver for mimicry lay in the desire by other firms to sell higher volumes of securities. To achieve this, they needed a wider spread of customers as local markets ultimately became saturated. The natural limitation of a local geographical market restricted a firm's ability to reach a broad client constituency. Therefore after observing the improvement in sales by S & M Allen & Co. other firms decided to imitate their successful geographical distribution strategy.

Albert Gallatin, the Secretary of the Treasury had to deal with the funding shortfalls of the government during the war of 1812. The following section discusses the sequence of events which led Gallatin to seek the assistance of a group of investment bankers who together developed an innovative technique to provide certainty of funds for the government. This was generically to be known as an underwritten securities issue which is still used today.

4.2.4 Albert Gallatin - Secretary of the Treasury

Figure 20 - Portrait of Albert Gallatin



Source: (Wilson n.d.).

The Secretary of the Treasury in 1812, Albert Gallatin, encountered difficulties in attempting to source the necessary funding for the War of 1812 from the private sector. In 1809, three years earlier, Gallatin had warned Congress of the dangers of not renewing the charter of the First Bank of the United States as the bank was a possible source of finance for the Treasury in the event of an emergency. At that time the federal government had been generally free of routine bank debt for approximately 10 years but Congress was not swayed by Gallatin's precautionary warnings (Heidler & Heidler 2004).

Following a realisation that the sale of lottery tickets was not going to raise sufficient funds for an impending war, Congress ultimately authorised the issuance of USD 11 million in new bonds at 6% interest in March 1812, three months before it declared war. Congress considered the amount and relatively low interest rate proposed for the new issue was within the appetite of the private sector given the perception that the US represented a solid risk. At that time the US had a sound international reputation with over 50% of its bonds held by foreign investors and was one of the few nations that had followed a consistent policy of paying down substantial amounts of its national debt for over a decade; less debt reduced the interest drain on budgets and lowered the risk of default. However uncertainties surrounding the war altered the investment climate (Heidler & Heidler 2004).

The Treasury Department had become accustomed to managing its bond sale programmes without assistance of private underwriters. The Treasury began accepting subscriptions in May 1812, but only USD 6.2 million of the initial offering was taken - USD 4.2 million by banks for their long term loan portfolios and USD 2 million by individuals (Heidler & Heidler 2004 p. 182). Meanwhile requests for military expenditures were accumulating. Gallatin might have considered offering the bonds at a discount price or increasing the interest coupon above 6% to attract more investors but these options were rejected by the then President, James Madison and his closest advisors. When it became clear that the terms offered to investors were insufficiently remunerative to raise the entire USD 11 million, Madison instructed Gallatin to seek permission from Congress to pursue an alternative strategy which had last been used in 1780 during the American War of Independence: the issuance of fiat paper money. Gallatin was aware of the inflationary problems related to the emissions of the Continental dollar during the American War of Independence. He considered as an alternative to fiat money, the issuance of short term debt instruments similar to the one and two year treasury notes issued by the colony of Massachusetts in 1751. The plan involved the issuance of negotiable treasury bills that were legal tender in public dealings but not in private transactions. These bills would have maturities of one year or less and carry an interest rate of 5.4%, slightly below the yields on the longer term US bonds (Heidler & Heidler 2004).

In June 1812, Congress authorised USD 5 million in treasury bills to cover the shortfall from the earlier bond sale. Over the course of the war the Treasury issued a total of USD 36.7 million in treasury bills, although no more than USD 17.6 million were outstanding at any given time (Heidler & Heidler 2004 p. 183). Most treasury bills were issued in denominations of USD 20, USD 100 and USD 1,000 which ensured they catered to most wealth classes of investors. In 1815, the Treasury issued approximately USD 2.75 million in bills in even smaller denominations of USD 3, USD 5 and USD 10 and bearing no interest. These small bills, tantamount to fiat money similar to the Continental dollar of the 1770s, immediately entered the money supply with the risk of fuelling inflation. These small bills constituted less than 4% of the Treasury's total indebtedness and their overall impact was fairly modest (Heidler & Heidler 2004 p. 183). Unlike the Continental dollar, the purchasing power of these small bills remained relatively stable since holders had the option of converting the bills at face value into long term government bonds paying 7% interest thereby creating a secondary demand for the bonds.

Meanwhile Gallatin tried to float another issue of long term bonds in early 1813. Congress authorised an issue of USD 16 million and given the shortfall experienced in the 1812 issue, military indecisiveness, and the opposition of many wealthy New England investors to the war, Treasury was allowed to pay a commission of 0.25% to private agents who solicited bond sales (Heidler & Heidler 2004 p. 183). This is another of the earliest examples of the acknowledgement that the Treasury could not fulfil the government's fundraising on its own and that it could turn to the investment banks for the much needed assistance. Whilst the Treasury was solely responsible for the routine government debt offerings, it was lacking the aggressive marketing expertise that these investment bankers could provide.

In response to its appeal for funds - the traditionally passive system of merely announcing a subscription date – the Treasury had received applications for only about one third of the sum required up to March 1813 which left approximately USD 10 million of bonds unsold. Gallatin was now prepared to consider any debt structures including higher interest rates, discounts on purchase prices, call rights and other features (Heidler & Heidler 2004 p. 183).

During the first week of April 1813, Gallatin engaged in negotiations with representatives of a syndicate of underwriters and investors. The three principals who could be considered as sophisticated investment bankers were Stephen Girard of Philadelphia, John Jacob Astor of New York and David Parish, the agent of an international banking house who had resided in Philadelphia since 1806. Refer sections 4.2.5, 4.2.10, and 4.2.6 for a more detailed background of David Parish, John Jacob Astor and Stephen Girard respectively. Parish, who was the lead arranger of the syndicate, was the son of the senior partner of Parish & Co., a firm headquartered in Hamburg, Germany. He was familiar with the techniques of forming syndicates and underwriting large issues of government securities and he transferred those

skills to the US capital markets. The syndicate agreed to underwrite the remaining USD 10.1 million of 6% bonds at a discount price of 88% of par which produced a current yield to investors of 6.8%. Between them, Girard, Astor and Parish took up a total of approximately USD 7.7 million on terms which they considered acceptable and earned USD 11,510 in commissions after costs for their services. The remaining underwriting amount was filled by independent firms in New York and Philadelphia which acted as junior members of the syndicate. These new syndicate members sold an additional amount of USD 2.4 million in bonds to various investors. The underwriting process provided the Treasury with the assurance that the funds were committed. It was then the responsibility of the syndicate members to place those bonds which they had underwritten to other investors (Heidler & Heidler 2004) otherwise the underwriters would be left holding any unplaced bonds in their own proprietary portfolios. With the co-operation of the private syndicate of investment bankers, Gallatin was able to avoid the embarrassment of a second unsuccessful or unduly prolonged fund raising campaign. Moreover, with total commissions representing a fraction of 1% of the total face value of the amount underwritten, the government was well satisfied (Heidler & Heidler 2004).

This underwriting process has remained unchanged ever since and is the cornerstone of the global debt and equity markets providing assurance to borrowers and users of capital that funding in whichever form would be provided by the underwriters of any particular issue. This precedent setting fund raising exercise in April 1813 is considered the first official US government involvement with financiers performing essentially investment banking functions. This association between government and underwriters was a singular event in the financing of the War of 1812. Despite the success of the public offering, the participation of underwriters was not repeated during the war. During the ensuing two years the Treasury stuck to the former practice of managing the distribution of new securities without the assistance of outside financiers (Heidler & Heidler 2004).

Gallatin resigned from the position of Treasury Secretary in May 1813, soon after the conclusion of negotiations with the syndicate. He was succeeded first by Secretary of the Navy, William Jones, (later president of the Second Bank of the United States), who served as acting Treasury Secretary until February 1814, then by George Campbell until October 1814, and subsequently by Alexander Dallas. William Jones managed to sell USD 8.5 million of 6% bonds at a discount of USD 88 in August 1813, on the same terms established for the successful bond issue by the syndicate three months earlier. Thereafter treasury secretaries had difficulty raising sufficient funds in the capital markets to cover military expenditures on equally favourable terms. They resorted to a mix of short-term treasury notes plus occasional sales of long-term bonds to keep the government afloat (Heidler & Heidler 2004).

4.2.5 David Parish - Underwriter and Social Networker

Figure 21 - Portrait of David Parish



Source: (Immigrant Entrepreneurship n.d.).

David Parish was a financier, property investor and trader from an English family which had important and influential connections throughout Europe. Parish spent time in Hamburg and began his fortune when he founded a commercial house in Antwerp. As mentioned in the previous section, he was later to play a major role in financing the US military effort in the War of 1812 and in chartering the Second Bank of the United States (Walters & Walters 1944, pp. 149-50).

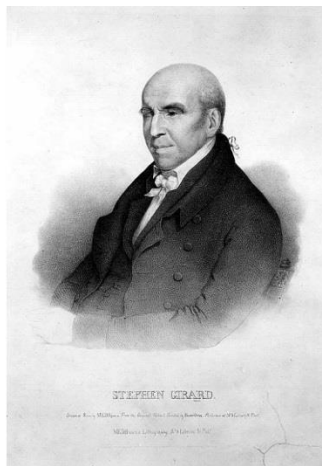
Following his move to the US in 1806, Parish commenced his property investment activities by purchasing vast tracks of land in Philadelphia, to onsell to new American settlers (Walters & Walters 1944, p. 157). Sympathetic to the anti-war Federalist Party, he nevertheless was instrumental in arranging the abovementioned USD 10.1 million underwriting syndicate for the US Treasury in 1813 to continue prosecuting the war. For that support, Parish gained the political leverage to insist on neutrality for the St. Lawrence Valley on the border between the State of New York and Quebec and on peace negotiations with the British in view of his business interests in the region (Taylor 2010).

Parish's efforts for peace contributed to a continuing commercial relationship between the US and Britain within a peaceful environment. He was able to use his social networks to become one of the most influential players in the international financial community (Taylor 2010). According to Schnurmann (2011) apart from his business and finance skills, his successful career was attributable to his personal charm, courage, and luck that allowed him to

confront and overcome many challenges. Parish's fortunes changed due to commercial failures following the banking crisis of 1826. His excessive pride and self-confidence affected his personal decision-making, as with some modern day executives of financial institutions that failed following the GFC, such as those of LB. As identified by Schnurman (2011), when hubris is combined with a banking crisis, a significant financial loss is likely. This pattern of a successful career based on attainment of power, hubris, leverage through social networks, courage and personal abilities parallels that of Richard Fuld whose successful career also came to an untimely end through a combination of hubris, miscalculations, and general problems connected with a financial crisis.

4.2.6 Stephen Girard - Financier, Patriot and Philanthropist

Figure 22 - Portrait of Stephen Girard



Source: (Brown 1832).

Stephen Girard was born in 1750 in France, the son of a sea captain and merchant. In his youth, Girard trained as a seaman undertaking voyages between France the US and the West Indies. His sailing skills proved useful when in 1776, he immigrated to the US where he established his own shipping business in Philadelphia. Like many financiers of his era, Gerard started his commercial career in a traditional and ordinary shipping business and used social networks and innovative practices to expand and exploit opportunities. An example of Gerard's innovative operating style is that he would warehouse goods imported from overseas until market prices reached optimal levels. This trading skill and market awareness may be viewed as a hallmark skill of any modern day investment banker where prior to the GFC, investment banks and in particular LB would warehouse mortgage securities for onselling once market conditions became favourable. Girard's shipping business expanded into trade routes encompassing China, Europe, the Caribbean and South America (Klem 2016). As Girard's wealth increased he diversified into the financial services sector by

becoming a majority investor in the First Bank of the United States immediately following the expiration of its charter. His investment also involved the purchase of the bank's headquarters on Philadelphia's South Third Street (Schroeder 2011). The bank was instrumental in assisting the US government in its financing of the War of 1812, therefore making the US government its major customer. As detailed in the previous section, Girard, was also a major participant together with Astor and Parish in the USD 10.1 million syndicated government fundraising. As with the other major participants, this involvement provided Girard with special access to the government executive and authorities. Girard used his role in the USD 10.1 million funding by simultaneously negotiating that in return the US government sold to him the majority of its shares in the First Bank of the United States (Cowen 2010). At the time of his death in 1831, Stephen Girard was the richest man in the United States (Schroeder 2011).

Girard – Saint or Sinner, Subjected to Normative Pressure

Girard is most famously recognised in the US as a generous philanthropist. He supported a wide variety of civic associations in his adopted hometown of Philadelphia. He contributed to a number of charities and social institutions such as to “the Pennsylvania Hospital, the Society for Relief of Distressed Masters of Ships and Their Widows, the Société de Bien-faisance Francaise, the Public School Fund of Philadelphia, the Pennsylvania Institution for the Deaf and Dumb, the Fuel Saving Society, and the Orphan Society, among many other groups” (Klem 2016).

Although Girard is well known for his philanthropic activities throughout his life, he was also prepared to undertake devious business practices. According to Henry (1918, p. 284) “Gerard was a smuggler himself and a deviser of ways that are dark and tricks that in one notable instance were vain”. Examples of Girard's dishonest activities included “lying, official declarations which were quite different of the cargo carried by his ships, gratifications for the customs inspectors, counterfeit passports and camouflaged ship ownership and consignees” (Henry 1918, p. 284). This acknowledgement that a successful merchant like Gerard was prepared to behave in such a manner is an indication of the times. Henry (1918, p. 284) suggests that people of that era “lived by cheating one another”. This normal-

isation of antisocial and dishonest behaviour was also evident in the lead up to the GFC when for example investment banks were selling almost worthless mortgage backed securities to unsuspecting investors¹⁷. In support of the acceptance of these practices is the fact that there is no record of Girard ever being convicted of any criminal or civil indiscretion. At worst legal authorities cast a blind eye, which as Zanna (1991, p. 202) explains is tantamount to “what is commonly approved – that is, what is socially sanctioned”. At best this behaviour was never discovered by the legal authorities, in which case the prevailing social norms, allowed for an under-resourcing of law enforcement agencies whether in personnel, training or motivation to detect and prosecute such misdemeanours.

The normative influences existing during this era regularised certain dishonest practices as a means of doing business as explained in the previous section. Further justification for these practices is found later in this thesis by way of similar questionable behaviours being normalised in the modern investment banking industry. A common feature of these practices within the field of finance and trading is the complexity of transactions. Large merchant businesses dealing with more complex international trade transactions encountered many obstacles and challenges in concluding the deals. These circumstances mirror the challenges which presented themselves to investment bankers in completing complex financial transactions in the pre-GFC period. Therefore given their complexity and relative remoteness from the purview of the legal and regulatory authorities, the indiscretions were successfully concealed, or at worst, ignored by the same authorities. A significant contribution of this section to the thesis is the recurrent theme of similar behaviours exhibited by traders and financiers over the centuries in the US.

4.2.7 American Railroads Expansion (1830 - 1850)

Much has been written about the economic and social development which was accelerated by the US railroad expansion during the period 1830 to 1850, so it will not be addressed in this section. Instead this section analyses the favourable impact this expansion had on the investment banking industry given the scarcity of long term capital. The dearth of capital

¹⁷ On 16 January 2017 Deutsche Bank settled a claim of USD 7.2 billion with the US Department of Justice for its misleading and dishonest behaviour in selling toxic mortgage backed securities to investors prior to the GFC (Wattles). Interestingly this claim took almost 10 years before it was finally prosecuted and settled.

drove promoters to seek funding through the bond and equity markets with a predisposition for the bond markets in Europe.

The funding of railroads underwent cycles of success and failure during the abovementioned period. Initially funding was relatively easily accessible, however once the economic impact on direct and indirect competitors to the railroads became apparent, funding for new railroads dissipated. Competitors which had a meaningful influence on new funding included stagecoach companies, canal operators, and turnpike companies (Kansas Historical Society 2011). Railroads were seen as an efficient and economical way of transporting people and goods between established cities and towns. In 1827, given the size of Baltimore, the project economics for a railroad, known as the Baltimore and Ohio Railroad, connecting Baltimore with other towns were deemed feasible. The railroad was initially envisaged to compete with the Erie Canal, which accommodated New York passengers, however through a number of extensions, it continued until it reached Parkersburg, West Virginia (Kansas Historical Society 2011).

Other railroads soon followed such as those based in Charlestown, South Carolina, and Albany, New York. As settlements across the US expanded, the federal government wanted to develop a trans-continental railroad connecting New York and San-Francisco. This railroad was constructed between 1863 and 1869 and became known as the Pacific Railroad (Linda Hall Library 2012). As the project economics of the trans-continental railroad were not apparent, the federal government granted public land to railroad companies via the Pacific Railroad Act, as an incentive to construct sections of track in selected areas. The government anticipated that the land grants would increase in value as the new settlements along the track expanded and demand for adjacent land increased. This would contribute to the profits or net worth of the railroad companies and therefore improve the project economics. Moreover, as railroads usually operated as monopolies between destinations, an ultimate profit was expected by the railroad companies. The Pacific Railway Act, also committed government financing by way of issuance of government bonds, which contributed USD 32,000 per mile of track laid to the two sponsoring companies, the Central Pacific Railroad and the Union Pacific Railroad. The balance of the financing was sourced from private investors (Linda Hall Library 2012). By 1860, US railroad mileage had more than tripled from a decade earlier. An indication of the expansion rate of railroads between 1830 and 1890 is given by the following table:

Figure 23 - US Railroad Active Mileage by Region between 1830 and 1890

Region	1830	1840	1850	1860	1870	1880	1890
New England	30	513	2,596	3,644	43,273	5,888	6,718
East		1,484	3,740	11,927	18,292	28,155	40,826
South	10	737	2,082	7,908	10,610	14,458	27,833
Midwest			46	4,951	11,031	22,213	35,580
South Central		21	107	250	331	1,621	5,154
West				239	4,578	15,466	47,451
Total USA	40	2,755	8,571	28,919	88,115	87,801	163,562

Source: (Porter 1892).

The support provided by government by way of land grants combined with the monopolistic nature of the railroad business in the early period of the industry, made financing this modern infrastructure an attractive and relatively low risk proposition for investment bankers (Porter 1892). As this was a capital intensive industry, which required large amounts of debt and equity from a country with a short supply, it was ripe territory for strong growth of the investment banking industry. The following section outlines some of the pioneers who initiated the required railroad financing.

4.2.8 Nicholas Biddle – Politician, Bank President and Financier to US Railroads

Figure 24 - Portrait of Nicholas Biddle



Source: (Longacre c. 1830).

Nicholas Biddle was born in Philadelphia in 1786. He was the son of Charles Biddle, who was a strong supporter of American independence and ultimately served as Vice President of the Supreme Executive Council of Pennsylvania under President Benjamin Franklin. Nicholas' uncle was regarded as a hero and died in the American War of Independence, whilst another uncle was a member of the first Continental Congress of 1774. This ancestry provided Nicholas Biddle an unusually valuable network of political and business connections (Hammond 1957, pp. 287-8).

Nicholas Biddle graduated with a degree at Princeton University at the age of 15. He followed his degree with further studies in law. Following his studies, Biddle began writing for a prestigious journal, Joseph Dennies' Port Folio and in 1804 became secretary to General John Armstrong, the American Minister in Paris. This job enabled Biddle to tour Europe and in 1806, he served the future US President, James Monroe, who was at that time, the Minister to the Court of St James in England (Hammond 1947). During this period, Biddle established many connections which would become useful in his later finance career, especially in the distribution of bonds to European investors. Hammond (1957, p. 287) describes Biddle as having "a superfluity of social and economic advantages". His network permeated both the US and Europe.

In 1807, Biddle returned to the US and began writing journal articles and books. In 1810, Biddle was elected to the Pennsylvania House of Representatives whilst his father was a member of the State Senate. Nicholas Biddle later also became a Senator of Pennsylvania and during this time sought a new charter for the Second Bank of the United States, following the expiration and non-renewal of the federal charter of the First Bank of the United States in 1811. The Second Bank of the United States was chartered in 1816 with the same responsibilities and powers as the First Bank. Biddle was initially appointed as a federal government director by the then US President Monroe and in 1823 succeeded Langdon Cheves as the bank's president. Under Biddle's leadership the bank assumed the role of a central bank and his interest in the welfare of the US economy inspired him to implement monetary policy to aid the government's attempts to expand economic activity. Biddle remained in this role until the bank's charter expired in 1836 (Hammond 1947).

Biddle was a major contributor in elevating Philadelphia to its primary role in railroad financing during the 1830s. He helped market the securities of the Reading, the Virginia, and some of the local Pennsylvania railroads (Chandler 1954). The Second Bank of the United States acted as the fiscal agent for the Reading and other coal railroads and was of prime importance in financing the Philadelphia, Wilmington and Baltimore railroads. His involvement with railroad financing earned Biddle the informal title of America's pioneer investment banker (Chandler 1954). He also used the Second Bank of the United States, "to funnel American securities into the London market directly and efficiently through its agent, Mr. Jaudon, planted in London for this express purpose" (Chandler 1954, p. 253).

In April 1836, the national charter granted to the bank by the Federal government expired, however Biddle was instrumental in ensuring the bank continued operating under a state charter to guarantee its status. In 1839, Biddle resigned as the bank's president, and in 1841, following the impact of the bank panic of 1837, the bank failed. Biddle was subsequently arrested on fraud charges but was later acquitted and died soon after (Hammond 1947). When the Second Bank of the United States failed, it had large holdings in nearly all the important privately financed railroads south of New York.

Biddle's Power from Knowhow and Networks

Biddle's network of contacts enabled him to assume important political and commercial positions, leading to his ascension to the top position in one of the largest banks in the US at the time. His influence and capacity to organise finance for the burgeoning railroad infrastructure in the US was vital for the development of the US economy. It is not surprising therefore that his knowhow, network, and credibility attracted favour from key individuals in the government executive and other prominent businessmen. The principal power exhibited by Biddle is identified by Clegg (1989) as that emanating from networks and knowhow which is transmitted from the facilitative circuit.

Biddle's networks enabled his progression as mentioned above, through political positions in government which in turn led to the influential position as the head of the Second Bank of the United States with the ongoing support of President Monroe. Biddle used this power to support the development of the US railroads and economy. In the process he ingratiated himself to the country's elite leaders which in turn served to increase Biddle's commercial success and influence even further.

The facilitative circuit is also where power is generated by techniques of production which is translated as the knowhow of arranging difficult financings. In this instance, Biddle's knowhow and skills in arranging large financings by using Europe as a distribution centre for the issuance of railroad bonds is representative of a relatively unique technique which empowered Biddle to reach the positions he eventually attained. In accordance with Clegg's (1989) framework, the resultant power favourably impacted Biddle's social relations in the episodic circuit with politicians and leaders of industry to facilitate his leadership position in the crucial railroad financing of the era.

4.2.9 Clark Dodge – Investment Bank Financier to the Early Railroads

Figure 25 - Portrait of Enoch Clark (founding partner of Clark Dodge)



Source: (Scharf & Wescott 1884).

Enoch Clarke, born in 1802, was another eminent financier instrumental in supporting the financing of the US railroad system. Clarke established his name as a prominent financier whilst a partner in the merchant bank S. & M. Allen and Co. which eventually failed following the panic of 1837 (Geisst 2006). S. & M. Allen and Co. was a founding member of the New York Stock exchange and during his time in the firm, Clarke gained a reputation as a stock trader and speculator (Geisst 2001).

Clarke subsequently began his own firm with his brother in law, Edward Dodge as partner. The firm was known as Clarke Dodge and Co. and specialised in trading banknotes and gold bullion. Clark Dodge & Co. soon established a sound reputation by guaranteeing the firm's notes with their own stock of gold and silver (Geisst 2001). The firm's reputation grew when it participated as a co-underwriter alongside merchant bank, Corcoran & Riggs in a bond issue for the federal government to assist in the financing of the Mexican War which began in 1846 (Geisst 2001).

As the firm expanded, it introduced new partners, including Jay Cooke, who was admitted in 1849. Prior to the Civil War, the firm participated in the underwriting of a number of bond issues on behalf of some of the earlier railroads such as The Pennsylvania railroad (founded in 1846), Rocks Island Line (founded in 1854), Northern Central (founded in 1858) and the Philadelphia and Erie (founded in 1861). These successful transactions generated significant esteem and earned the participating firms generous fees (Chandler 1954; Geisst 2001).

Clark died in 1856, a year before the panic of 1857. As with all panics, the viability of merchant banks generally becomes strained. Clarke Dodge closed its operations temporarily following the panic of 1857 and by the time Clark Dodge recommenced operations, Jay Cooke,

one of the most successful partners in the merchant bank, departed to open his own firm (Geisst 2006). Clark Dodge continued operating until 24 June 1974 when it was acquired by Kidder Peabody (Geisst 2006). Like many other investment banks, Clarke Dodge had been incurring losses in the early 1970s, and Kidder Peabody, recognising the valuable distribution capability of the firm was able to justify the acquisition (New York Times 1974).

Distribution Capability as Technology of Production

Clark Dodge & Co. was typical of the various investment banks of its era which often relied on effective distribution networks for the sale of bonds. The ability to reach investors with appetite for bond investments is considered a crucial skill of any firm. The wider distribution network the larger the potential volume of bonds that can be underwritten. It therefore follows that the higher the value of bonds underwritten the greater the potential profits for the firm.

This distribution capability was equally important for the financing of the US railroad expansion as it is today for any corporate bond issue. A cornerstone of the development of valuable distribution capability is a network of social relations amongst other investment banks and wealthy investors. The power of individuals within a firm is facilitated by the possession of superior knowhow and technology. This knowhow extends to the ability to develop effective distribution networks. In creating these networks a reputation for reliable delivery of credit information on issuers and structuring and pricing of suitable capital market transactions is essential in order to generate sufficient investor appetite for a successful issue. Therefore the knowhow required to deliver arrange securities issues and ensure their effective distribution is an important factor for an investment banking firm intent on participating in this sector of the market.

4.2.10 John Jacob Astor Benefits from US Legislation

Figure 26 - Portrait of John Jacob Astor



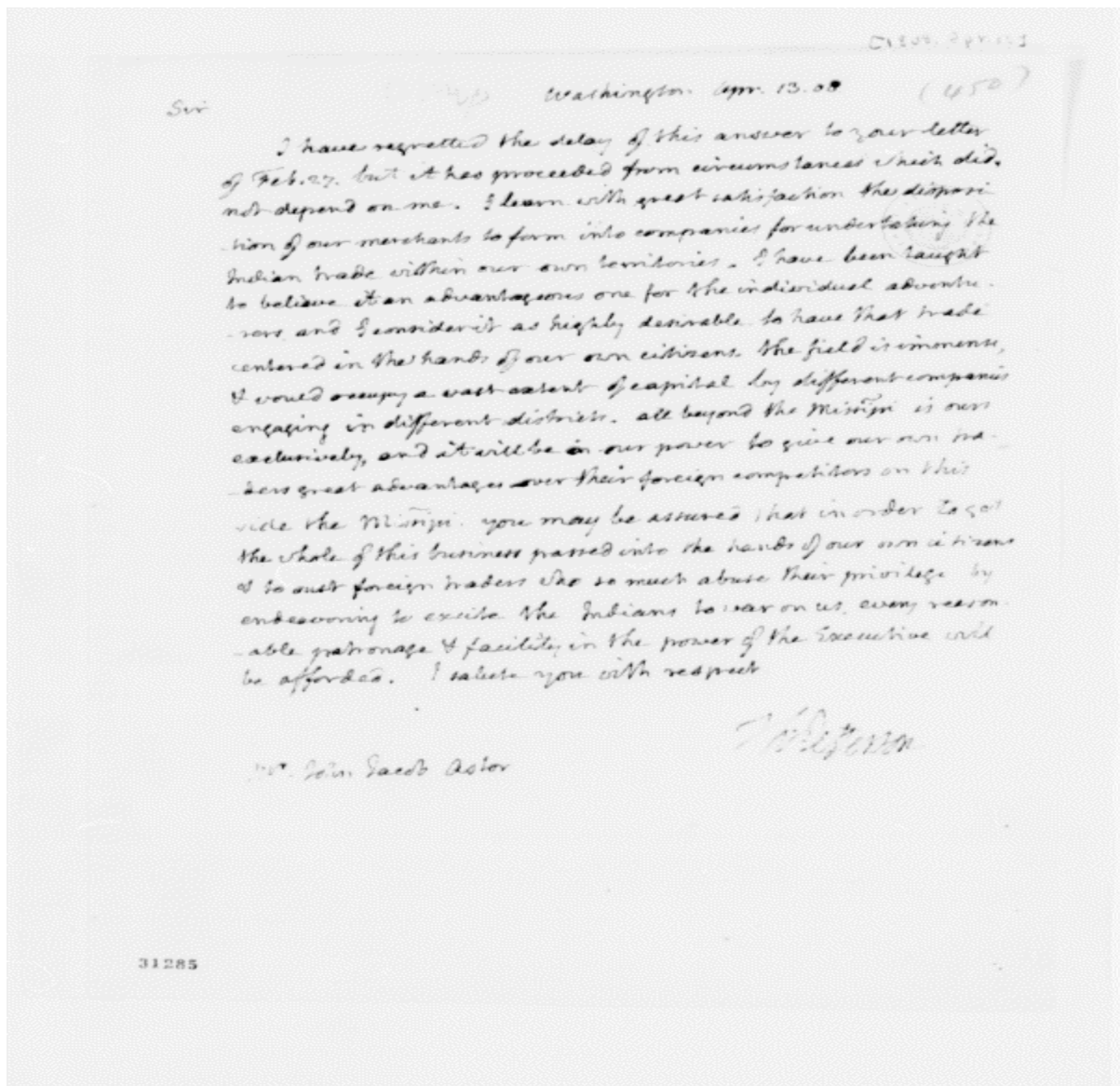
Source: (Jarvis 1825).

John Jacob Astor was born in 1763 in Germany and migrated to the US in 1784 at the age of 21. This period signalled the end of the American War of Independence. Through his busi-

ness interests in the US, Astor became one of the wealthiest men in the US and its first multi-millionaire (Bernstein & Swan 2007). Astor first developed his sales skills and business acumen whilst working as a salesman in his father's dairy business in Germany at a very young age. Destined for a career in commerce, he further refined his business skills at the age of 16 once he moved to London to work for his brother, George Astor, manufacturing musical instruments. This provided Astor the opportunity to learn English (Klepper & Gunther 1996). Following his emigration to the US, Astor practiced his business skills by entering the fur trading sector and by the late 1780s established a fur goods retail outlet in New York. He also became the New York agent of his brother's musical instrument business (Klepper & Gunther 1996).

He soon started exporting furs to Europe and expanded his business to China where he exported furs, sandalwood, tea and furs. In the process Astor began accumulating a significant amount of wealth. His trading business was temporarily affected by The US Embargo Act in 1807, which prevented trade with France and Britain however this restriction was relaxed in 1809 (Encyclopedia Britannica 2015). Astor's importance to US trade was recognised by Thomas Jefferson, and Astor used his influence to gain Presidential approval to establish the American Fur Company on April 6, 1808. Through his group corporate structure, Astor soon controlled trading in the Columbia River and Great Lakes areas (Klepper & Gunther 1996). Jefferson welcomed Astor's entrepreneurship and acknowledge its importance to US economic development. The letter below (Figure 27) quotes Jefferson as stating "I learn with great satisfaction the disposition of our merchants to form into companies for understanding the Indian trade within our own territories"(Jefferson 1808a).

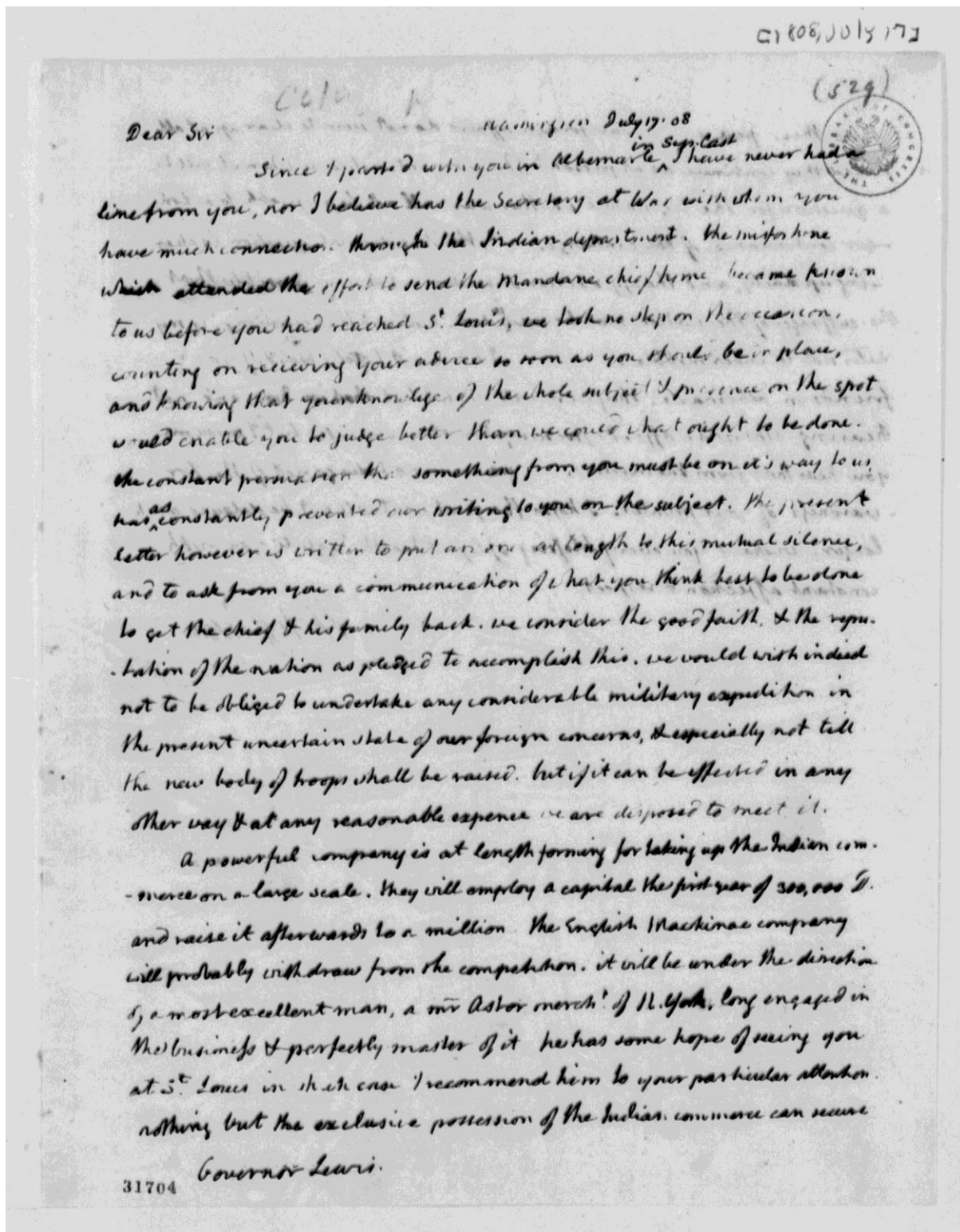
Figure 27 - Letter from Thomas Jefferson to John Jacob Astor, 13 April 1808



Source: (Jefferson 1808a).

In the letter below to Meriwether Lewis Figure 28, Jefferson expressed his opinion of Astor as "a most excellent man" (Jefferson 1808b).

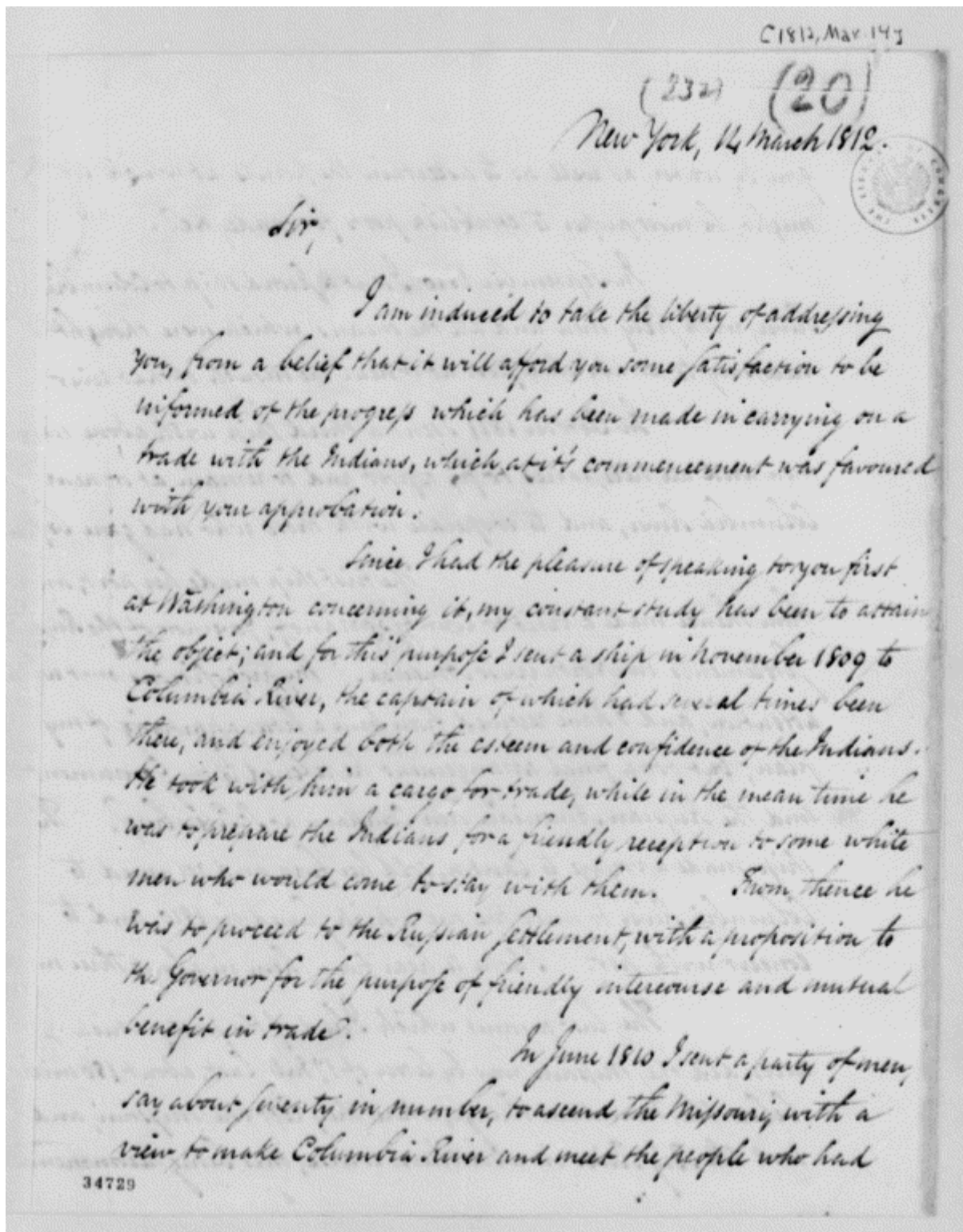
Figure 28 - Letter from Thomas Jefferson to Meriwether Lewis, 17 July 1808



Source: (Jefferson 1808b).

Figure 29 demonstrates Astor's continuous contact with the President regarding his group's ongoing business activities (Astor 1812).

Figure 29 - Letter from John Jacob Astor to Thomas Jefferson, 14 March 1812

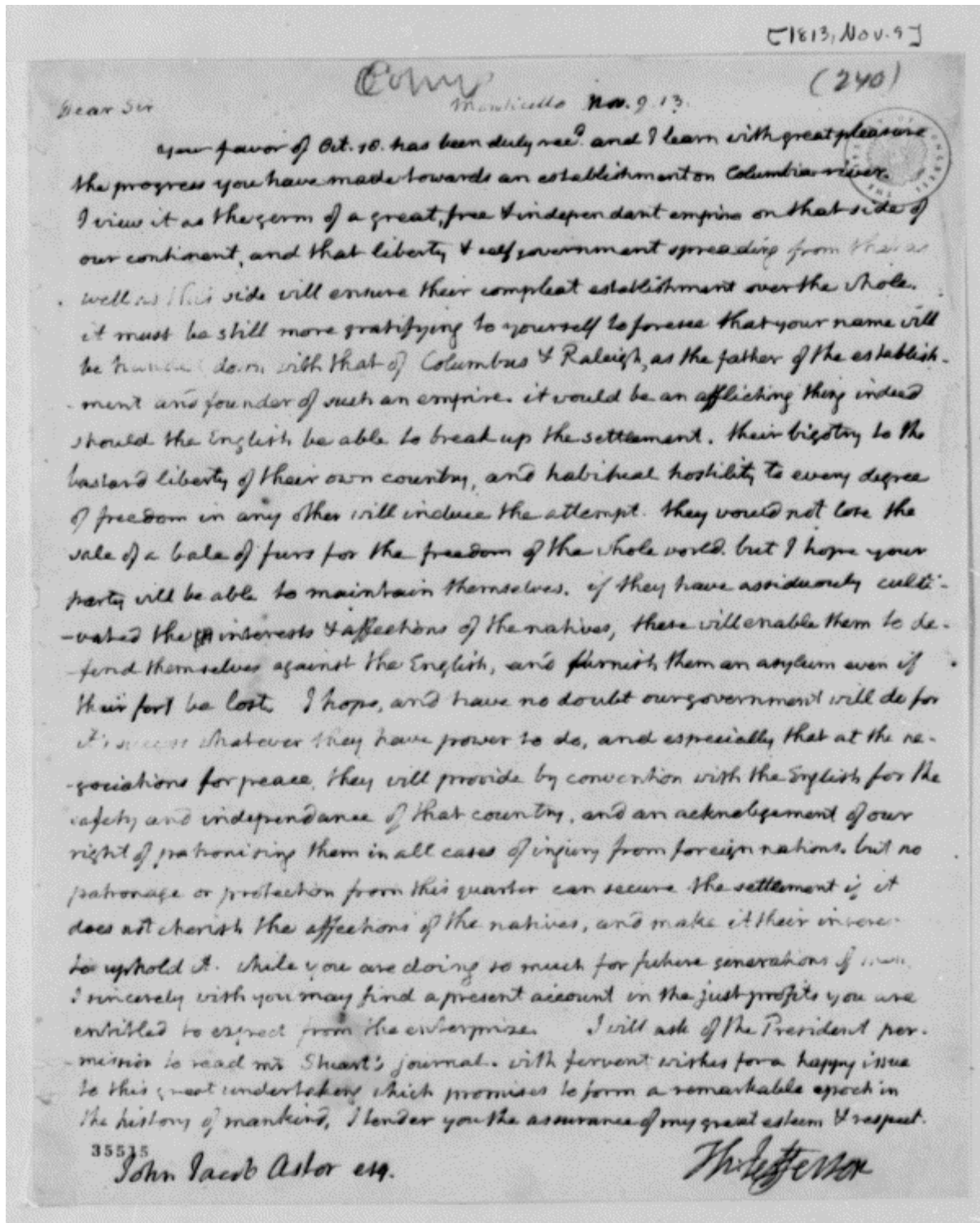


Source: (Astor 1812).

Further evidence of Astor's desire to court the interest of the most powerful leader in the US is outlined in the following letter by Jefferson depicted in Figure 30 wherein he stated, "I

learn with great pleasure the progress you have made towards an establishment on the Columbia River" (Jefferson 1813).

Figure 30 - Letter from Thomas Jefferson to John Jacob Astor, 9 November 1813



Source: (Jefferson 1813).

The examples of correspondence above provide an insight to the strong relationship Astor was able to develop with the President of the US. Jefferson naturally was interested in fostering economic trade for the ongoing prosperity of the new nation and Astor, knowing this priority within Jefferson's agenda, ensured he kept himself and the developments surrounding his companies, front of mind with Jefferson and the government. It is therefore not unexpected that as Astor required certain dispensations from the government that they were granted without challenge or bureaucracy.

During the War of 1812, Astor's fur trading hub, which was structured as a fort and located on the US west coast, was ceded by the British. This action by the British reaffirmed Astor's belief of the repressive nature of the British and reinforced his loyal convictions towards the US Congress. Aside from the capture of his trading fort, Astor did not escape the War of 1812 without a substantial profit. Like many financiers described in this section, Astor was able to use an influential network of connections, especially in government to secure concessions allowing him, in effect, to continue the fur trade in Canada throughout the war (Klepper & Gunther 1996).

Together with Stephen Girard and David Parish, Astor was able to assist the US government in the USD 10.1 million syndicated fundraising described in section 4.2.4. The income generated by this financing together with an expanded property portfolio in New York, enabled Astor to accumulate significant wealth. Astor became "immensely wealthy and ready to take over virtually the whole of the American fur trade" (Stokesbury 1997).

Astor's Preferential Treatment – An Exercise of Power and a Normative Influence

Given the US government's precarious financial position towards the end of the War of 1812, and Astor's immediate financial assistance, a sense of obligation was created between a grateful US government and the syndicate members of the USD 10.1 million financing transaction, including Astor. In 1816 Astor capitalised on this sense of obligation and attempted to influence the US government to prevent Canadians trading in furs unless employed by a US firm. The US government consented to Astor's request by enacting legislation on 29 April 1816:

John Jacob Astor, already a power in the Wisconsin trade, saw his opportunity. Having secured the passage by congress of an act April 29, 1816, by which foreigners were excluded from any participation in the fur trade within the United States except in subordinate capacities under American traders, he cleverly began through his agents to enlist the distressed French traders of Wisconsin in the service of his American fur company (Way 1919, p. 226).

This enlarged Astor's business empire and granted his group control over all fur trade with the Great Lakes region of the US (Stokesbury 1997). Equally in 1816, through Astor's hubris generated by the US government's sense of obligation, he illegally directed his American Fur Company to purchase 10 tons of Turkish opium, which was exported to China on the ship 'Macedonian' (Frontline 2011). When he ceased his business with China, he instead exported opium to Britain (Frontline 2011). None of these illegal actions attracted the scrutiny of US law enforcement agencies. Whether this inaction was due to incompetence, a sense of obligation and awe of Astor's power or carefully negotiated arrangements with US authorities, Astor, had effectively enriched himself at the expense of the legal system under the government's authority. It was during this time that Astor agreed to jointly underwrite the abovementioned US government USD 10.1 million bond issue, whilst concurrently receiving concessions from the US government for his fur trading. Astor's influence with powerful government individuals also extended to property transactions. In 1804, Aaron Burr was serving as Vice President under then President Thomas Jefferson. Burr was in dire need of cash and needed to sell what remained of a 99-year lease he owned on a property located in New York. Astor was sought out by Burr, who knew Astor well through his dealings with government. Knowing of Astor's vast wealth, Burr solicited Astor to buy the lease which expired in 1866 for USD 62,500 (Bernstein & Swan 2007). Astor negotiated the transaction based on it not being brought to the market for competitive bidding. Not only did Astor once again prove useful to a US government official by executing a much needed property transaction, he also generated considerable wealth by subleasing parcels of the property to private investors (Bernstein & Swan 2007). Bernstein and Swan (2007) signal this transaction as instrumental in Astor's business career and journey to become one of the richest men in the US.

In the above examples Astor exercised power through his influence on the government to pass legislation to limit Canadian competition in his fur trade; avoid prosecution for his opium trading; and build on his wealth through the acquisition of Burr's property lease. In each case, Astor was able to influence some if not all of these outcomes through the use of his government relations facilitated by his financial support. Astor's activities were set within the historical context of the War of 1812 where the government was in need of Astor's financial assistance. This provided the exogenous environment required as the setting for the transmission of power in Clegg's (1989) dispositional circuit. In this circuit, rules of practice and socially constructed meanings inform social relations. Although this circuit is where socially constructed meanings in the work environment are often found, in Astor's case, the impact on social relations were created through a social obligation. Through the obligations created with the US government, and his frequent correspondence with the President which contributed to the positive impression formed of him by the President himself, he was able to establish an expectation that favours would be offered in return. This notion of obligation where an expectation is created represents an unspoken meaning constructed within a so-

cial context of the relationships Astor formed. The empowerment was exercised through the episodic circuit where Astor's desired outcomes were achieved. Within these social relations, Astor was able to assert influence in the enactment of legislation, the turning of a 'blind eye' to criminal activity and being the 'go to man' when funding was required.

As well as representing an exercise of power, Astor's situation also indicates normative and mimetic influences. The normative influence is revealed through relationships between law enforcement authorities and contemporary key individuals also involved in investment banking activities. For example, illegal activities by Stephen Girard were also ignored by law enforcement authorities (see below). In both Girard's and Astor's cases, the authorities chose to ignore the illegalities or indiscretions. This lack of action represents a type of social influence where an acceptance of common practices is seen as, justifying the behaviour. Normative pressure is commonly found within a social group where actions can be defined by moral duty and standards. In accepting Astor's actions, the groups in which he socialised comprising other businessmen, government officers and authorities tolerated a level of illegal behaviour as a cultural norm. The mimetic influence is however located between the investment bankers themselves. As one investment banker noted that another was able to escape conviction on illegal practices, the other copied the same behaviours in the expectation of escaping legal scrutiny and generating abnormally high profits.

Therefore Astor was able to achieve his desired objectives without sanction through a combination of: the power generated through the sense of obligation; the normative pressures permeating the social relationships between the institutions and Astor; and the mimetic pressure between members within the industry to copy certain behaviours in anticipation of greater benefits.

4.2.11 The Role of Bonds in Funding Railroads

As mentioned in the previous sections of this chapter, investment banks became an important conduit for the issuance of bonds for the financing of railroads. In the 1830s US railroad companies either chose local investment banks such as Clark Dodge & Co. and Thomas Biddle, or London-based investment banks to undertake the role of underwriter and distributor of bonds. The importance of the size and quality of social and commercial networks in the distribution of bonds is well demonstrated in the period between 1840 and 1850. During this period, the US investment banking industry was converging on New York, which, as the new major financial centre, was the destination for most railroad and canal companies in their fundraising efforts. The New York-based investment banks had the capability to distribute bonds in the Eastern regions of the US as well as to Europe. These vast regions relied on strong commercial and social networks to reach the ultimate investor. However, given the remoteness from the investor base, particularly in Europe, it was difficult for the New York investment banks to distribute equity, which represented the riskier form of capital.

Instead, investors preferred to invest in the less risky bond instrument. Since the equity issued by railroad corporations was generally considered a riskier form of investment, the performance, operations and risks associated with the railroad project generally required a greater level of monitoring. Alternatively, bonds paying a fixed amount of interest, a condition preferred by European investors, represented a less risky form of investment, and therefore required a lower level of risk monitoring.

However, in contrast with European investors, New England investors expressed a greater preference for equity as opposed to debt instruments. The social and commercial networks in New England were considered more closely knit than elsewhere in the US. The manufacturing and mercantile community of New England and specifically, Boston, where most wealthy investors resided, represented one of the country's primary investment markets. Given the strength of relationships throughout this community, railroad promoters had enhanced access to the ultimate investor which often obviated the need for an investment bank as a conduit for bond issues. Railroad companies could often issue directly to the investor and given the relational closeness and physical proximity between the parties, the risk monitoring by the investor was less problematic. This led investors in the region to be more amenable to equity issues in preference to bond issues. This preference for equity capital soon changed by the 1850s, as the amounts required for railroad expansion exceeded the available equity capital in the region (Chandler 1954).

By the beginning of the 1840s, various states were acknowledging the economic benefits of railroads. However in this early phase of railroad expansion, private capital willing to invest in railroads was relatively scarce. The states stepped in by arranging large state guaranteed public bond issues. These included issues by the states of Massachusetts, Pennsylvania, Virginia, South Carolina, Georgia and several of the new states of the West. Given the scale and cost of the railroad projects, combined with the risk related to the uncertain prospects of a sustainable profitable business, willing private investors during this period were relatively difficult to find. Consequently public issues became the norm (Chandler 1954, p. 249).

Critical to arranging much needed financing were the personal and business networks of the investment bankers in the Eastern States. This aspect of investment banking is similar to the traditional role of the investment banker in raising capital for specific projects or companies from sources usually well known to the firm. Toward the end of the 1840s, the firms of John E. Thayer and Brother and Henshaw and Ward began creating a liquid market for railroad securities and fostered relationships within their personal networks to sustain the development of the secondary market in these securities. The importance of personal networks in raising finance is exemplified by the capital raising for Michigan Central, Boston's largest single railroad venture in the West. In this fund raising, John E. Thayer and Brother and John Murray Forbes sold securities for the project to stockholders such as –"Perkins, Cushing, Quincy, Weld, Neal, Brown from a Who's Who of the closely knit, family related inner circle

of mercantile and manufacturing capitalists who dominated New England's economy" (Chandler 1954, p. 259).

Figure 31 - Obituary of Nathaniel Thayer

OBITUARY.

NATHANIEL THAYER.

Nathaniel Thayer, the well-known banker and capitalist, of Boston, died in that city yesterday morning. Mr. Thayer was a native of Lancaster, Mass., where he was born 75 years ago. He was the son of the Rev. Dr. Nathaniel Thayer, whose father, also a clergyman, was a lineal descendant, on the maternal side, of the famous John Cotton. Dr. Thayer was minister in Lancaster for more than 50 years. The son received a common school training, and when yet a youth went to Boston to enter into business. Here he early established with his brother a banking firm under the title of John E. Thayer & Brother. Their business related largely to the railroad enterprises which have opened over the great West. Many of their enterprises in this direction were, however, conducted as separate risks. They were generally successful, and the partners individually and as a firm received large profits. Among the earliest of the railroad enterprises in which Nathaniel Thayer was personally concerned were certain roads in this State, which were afterward consolidated into the New-York Central system. Subsequently he took a leading part in the completion of the Michigan Central Road. The Chicago, Burlington and Quincy Road is another of which the construction and early success were mainly owing to his far-sightedness, courage, and ability. It proved to be one of the most profitable of his undertakings. The Philadelphia, Wilmington and Baltimore was one of the roads in which he was concerned with his brother, John E. Thayer, and the advancement of the Hannibal and St. Joseph, which was originally undertaken by John E. Thayer, was assumed and carried through by Nathaniel after his brother's death. Other railroad schemes of less magnitude engaged his attention from time to time. Not all of these prospered, but the great rise of values after the panic of 1873 had spent its force yielded him large returns, for he was an extensive holder in the panic period of Western railroad stocks which were intrinsically good. Other capitalists joined him in many of his enterprises and prospered as he prospered. Mr. Thayer's achievements in contributing to the development of Western railroad property were less noteworthy in some respects than his work for Harvard College. He was one of the most munificent benefactors of the university. His direct benefactions exceeded \$250,000, and included his expenditures on Thayer Hall, Thayer Commons, the Gray Herbarium, and the Thayer Expeditions. This sum is in addition to a considerable amount which, for a long series of years, through channels of his own choosing, he had distributed as pecuniary aid to students in the university and to scholars in preparation for that institution. In 1865 he provided, in accordance with a suggestion by the Rev. Dr. Peabody, a place and means for such students as wished to avail themselves of a commons hall for boarding in company and at reasonable rates, after the former arrangements had been given up and before the dining-room in Memorial Hall was ready for use. To this end he established Thayer Commons Hall. During the same year Mr. Thayer made arrangements to provide for the cost of a scientific expedition to Brazil by Prof. Agassiz. The expedition covered a period of about a year, and cost a large sum of money. Mr. Thayer also assisted Prof. Agassiz in many other scientific enterprises. Thayer Hall, which was erected at a cost of over \$100,000 in 1870, was designed by the donor as a memorial gift commemorative of his brother, John E. Thayer. It is one of the largest and handsomest of the structures on the college grounds, and is used as a dormitory. Mr. Thayer received the honorary degree of M. A. from the university in 1866, and served on the Board of Fellows. He married Cornelia Van Rensselaer, of Albany, who, with six of their seven children, survives him.

Source: (New York Times 1883).

Figure 32 - Portrait of Nathaniel Thayer

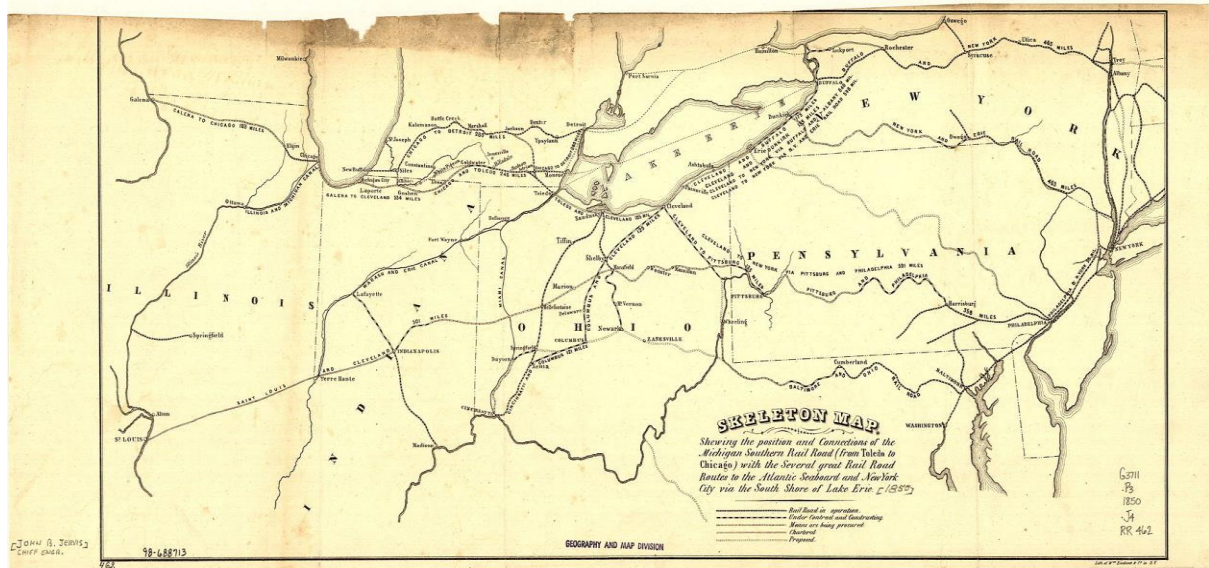


Source: (Ellis 1885).

In his obituary above, Nathaniel Thayer was reported as receiving large profits from the financing of the railroad expansion. New York Times (1883) attributed his success with the railroads to his “far-sightedness, courage and ability” a trait which is common amongst some investment bankers to this day.

By the end of 1847, the railroad industry realised that traditional vanilla bond issues could no longer meet the full financing requirement of additional large Western railroads. The depression of 1847 resulted in a reduction in available capital and forced investment bankers to complement the traditional source of funding with alternative and innovative ways to raise the necessary railroad financing. Consequently, the Michigan Central railroad issued USD 1,000,000 of 8% convertible mortgage bonds which were successfully sold to the public. The convertible mortgage bond became the preferred instrument of financing for railroad projects. The mortgage was typically over the assets of the railroad including land to provide security to the investor. The convertible nature of the bond however was an option to convert the bond into a dividend paying equity instrument intended to reward the investor once the railroad was generating significant income and provided for capital growth. This style of financial product is often used by investment bankers today for various financing opportunities and represents the creative and innovative skills developed by US investment bankers during the formative years of the industry.

Figure 33 - Map from 1850 of the Michigan Southern and connecting railroads



Source: (Jervis 1850)

4.2.12 James Gore King – ‘Merchant Prince’ and the ‘Almighty of Wall Street’

Figure 34 – Portrait of James Gore King



Source: (Mott 1899, p. 32).

Born in 1791 in New York City, James Gore King was another individual who led a successful career as a politician and investment banker. King was well educated having studied law at Harvard University and graduated in 1810. Whilst in Paris, he also studied languages.

In 1813 King married Sarah Rogers Gracie, whose father Thomas Fitch was a colonial Governor of Connecticut. This connection helped King to serve as Assistant Adjutant General of

the New York Militia in the War of 1812. His commercial career began as a Mercantile agent in New York City in 1815 (King 1854). His commercial experience led King to establish a banking firm in 1818 known as King & Gracie, in Liverpool, England with his brother-in-law, Archibald Gracie Jr (Weygant 2016). He returned to New York City in 1824 and engaged in banking as a partner in the firm of Prime & Ward (later known as Prime, Ward & King) before leaving this firm to form James G. King & Son. King had an estate in Weehawken, New Jersey named Highwood and became known as “the ‘Merchant Prince’ and the ‘Almighty of Wall Street’” (Litchfield Historical Society 2010). In 1835, King accepted another prominent position as the President of the New York and Erie Railroad (Markham 2002). According to his obituary King was involved in “one of the wealthiest banking firms in the country” (Times 1853). His political career as a member of the US House of Representatives over the period 1849 to 1851 was short lived in view of his preference for commercial pursuits (Weygant 2016).

King’s ability to combine leadership roles in politics, industry and his domestic and European networks facilitated his business of securities dealing. These networks assisted in providing much of the necessary funding for the US railroad expansion. Again the associations with both government and the elite in business circles proved useful in generating his substantial wealth.

4.2.13 New York needs the help of Europe and Britain

In the 1850s as the railroad expansion escalated, and the demand for capital from other non-railroad corporations increased, the ability of New York to absorb numerous bond issues became increasingly difficult. As railroads accounted for the major share of bonds outstanding in the 1850s, investors became overexposed to this industry, which had the effect of raising risk levels within portfolios. Fortunately, the funding gap was met by European investors. As the centre for international merchant transactions and the associated trade finance with Europe, New York was the conduit for sourcing most of the funds emanating from this region. The key players in New York comprised investment banks which possessed links with those based in Europe, and most of these connections originated from US individuals who either travelled through Europe, or were born in Europe and had immigrated to

the US. Merchants with trading relationships in Europe also participated in the distribution of US bonds to European investors (Chandler 1954, p. 263).

Baring Brothers, a British merchant bank which was heavily involved in the securities used to finance the War of 1812, became the agent for many American businesses in London. It also used Prime, Ward and King as its agent in New York. The interest in US securities increased from 1922 when the “Navy Five Percents”¹⁸ were being refinanced with 4% bonds. London investors became disaffected with the lower return and thus appetite grew for alternative higher yielding bonds. The timing was ripe for the US issuer market as it constituted a high volume source for higher yielding bonds and securities. Brokers began to capitalise on this increasing appetite and established marketing agents in London. Charles Deveau was one such broker who established a capability to sell American securities in London and bonds were even sold on consignment through English brokers or correspondents. During this time the business of Baring Brothers and Co. continued to grow. Barings had two partners in the US before the Civil War, Joshua Bates and Russel Sturgess and a special agent in Boston, Thomas Wren Ward (Markham 2002, p. 166). During the 1850s investments in railroads totalled approximately USD 1 billion (Markham 2002, p. 165). The mortgage bond became the issue of choice for New York based investment banks who raised the bulk of the financing for the railroad expansion during from the 1860s onwards, supplanting the role of Boston during the 1840s and Philadelphia in the 1830s (Markham 2002).

Baring Brothers had noted the expanding need for capital in the US and attempted to cleverly use its US political contacts, in particular with the then US Secretary of State Daniel Webster, to position itself as a key player in the bond distribution process. Webster was appointed as a consultant to Barings and thus was able to profit also from this relationship. Barings’ involvement with the US government extended to encouraging a former head of Barings to assist Webster negotiate a treaty (known as the Webster-Ashburton Treaty) which ended the Aroostook War¹⁹ between the US and British North American colonies and

¹⁸ The Navy Five Percents referred to British bonds paying coupons of 5%. These bonds were used to finance the purchase of goods and services by the British navy.

¹⁹ The Webster–Ashburton Treaty, signed August 9, 1842, was a treaty resolving several border issues between the US and the British North American colonies. It resolved the Aroostook War, a nonviolent dispute over the location of the Maine–New Brunswick border. The treaty was signed by US Secretary of State Daniel Webster and British diplomat Alexander Baring, 1st Baron Ashburton

settled disagreements over border claims in the Maine - New Brunswick area. Barings involvement in the negotiations was a pre-condition to it marketing further US bonds in Europe (Wilson 2007, p. 149). This was not surprising given the close relationship Barings had with the US Secretary of State as a paid consultant, which involved a conflict of interest on both sides. Firstly concerning Daniel Webster, who whilst being on Barings' payroll, encouraged the appointment of Barings in the marketing role for US bonds. Secondly, on the part of Barings since it was an advantage for them to help settle disputes over the Maine-Canada border as this allowed the credit markets to flourish. This was essential for trade within the region, including that in which Barings had an interest.

Barings was never able to fully capitalise over its privileged position with the US government in view of the US government's financial difficulties following the panic of 1837 (Sexton 2003, p. 26). The panic resulted in the default of eight US states and given that British banks held large quantities of US debt, they used their influence to encourage the US states to prioritise repayments to British creditors. According to Sexton (2003, pp. 27-8) "London bankers responded, by mounting behind-the-scenes public-relations campaigns in the US. By distributing campaign contributions and commissioning an anti-repudiation magazine and newspaper articles, the London bankers helped to convince several states to resume payments on their debt".

This example of the exertion of power directly benefitted British bankers as interest and principal payments continued. The influence exerted by these bankers was only made possible by their considerable resources and the leverage they had as one of the few providers of capital open to the US states at the time. In the late 1840s and 1850s, British bankers continued to support US relations, in the hope that the support would translate to continuing business and as a mechanism to encourage reciprocal support in times of US difficulties (Sexton 2003). The influence exerted by a regional cohort such as the British bankers, is likened to a cohort brought together by ethnicity and religion such as the Jewish connections known as 'Our Crowd' who played a significant role in the development of the US investment banking industry.

4.2.14 'Our Crowd' and the 'Yankee Houses' – Subjects of Mimetic Pressure

As discussed in CHAPTER 4, an understanding of the history of investment bank partnerships also allows an appreciation of the history of the influence some participants carried in corporate and government circles. Many firms in the US were Jewish by origin, for example: J & W Seligman, Goldman Sachs, August Belmont & Co., Kuhn Loeb & Co., Lazard Freres, Salomon Brothers and Dillon Read (Geisst 2001, p. 4). This Jewish group was known as 'Our Crowd'. Although many conspiracy theories evolved over the years ranging from the clandestine control of the Federal Reserve to being the invisible power behind many a political

power base, there is no evidence that their influence was any greater than that of their non-Jewish counterparts, the 'Yankee Houses', such as Brown Brothers, J.P. Morgan & Co., Kidder Peabody and Clarke Dodge & Co. (Geisst 2001, p. 4).

US firms lacked connections to generate sufficient volumes of business in Europe where banking was considered more sophisticated and where demands for credit up until the 19th century was greater (Geisst 2001). This drove a degree of insularity amongst the industry in the US and a need to form informal communities domestically in order to share ideas, experiences and opportunities. For example, the second generation of the Lehman Brothers family formed strategic friendships with their counterparts at other Jewish-American firms. Philip Lehman in particular was closely associated with Henry Goldman, the son of Goldman Sachs' founder. Goldman and LB participated together in many investment banking transactions. The two firms agreed not to compete with each other for new business and this agreement and alliance was a critical reason for LB's achievements in the late 19th and early 20th centuries (Geisst 2001).

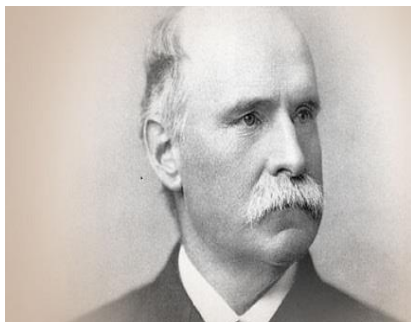
As discussed in detail in section 5.1.3, the use of syndicates to underwrite new securities issues had become a popular technique in the early 1900s and as transactions grew in size it became difficult for an investment bank to solely underwrite any single issue, primarily given the firms' own capital constraints. The desire to share underwriting risks so a firm's capital would not be overly exposed to an unsuccessful securities issue was equally as important to a firm's desire to share opportunities to participate in one another's transactions. The very nature of syndication requires firms to co-operate, preferably within a friendly 'community' (whether in the 'Our Crowd' or 'Yankee Houses' community), as repeated sharing of opportunities promoted continued survival (Geisst 2001). This necessitated firms with similar outlooks on risk and market conditions working together. Section 5.1.3 argued that the conformity of using similar financing techniques such as syndications is a result of normative pressures. These normative pressures allowed the practice of syndication to survive until the modern era as it is accepted as a safe and legitimate way to process securities transactions.

The repetitive behaviour of sharing in transactions for large and prestigious borrowers spread throughout the industry from a common desire to survive and grow and therefore emanated from DiMaggio & Powell's (1983) mimetic pressure. The strategy of pursuing relationships with larger organisations and especially government was mimicked within the investment banking industry for two reasons. Firstly, it was hoped such clients would provide a continued stream of large and lucrative transactions. Secondly, these relationships with influential organisations would foster an expansion of their networks and create an impression to the market that the firm was a preferred option, given the importance of its clientele and track record. Networks were useful for future business and as an instrument in pushing a point of view with government and regulators.

The majority of the perceived influence that investment banks possessed stems from the relationships some had with government. As discussed in CHAPTER 4, almost since the beginning of the Industrial Revolution, the US government had relied on the investment banking industry. This led to relationships which can be described on a continuum from institutional in nature to personal. For example, the Seligmans had a close relationship with Ulysses S. Grant, a leader of the Union army during the Civil War and the 18th President of the US between 1869 and 1877. As already discussed in this chapter, Jay Cooke of Clarke Dodge & Co and later founder of Jay Cooke & Co had a personal relationship with the US Senator and Governor Salmon Chase as US Treasury Secretary under President Abraham Lincoln and as the sixth Chief Justice of the US Supreme Court. It was as Treasury Secretary during the Civil War that Salmon Chase enabled Jay Cooke to win the mandate for selling the very large bond issues needed to finance the Union's war effort during the Civil War. Bankers from Kuhn Loeb & Co. and LB were instrumental in advising the government on the establishment of the Federal Reserve between 1908 and 1912. As discussed in section 4.2.19, the perceptions of influence with government which disenchanted the public in the early part of 20th century largely instigated the Pujo Hearings of 1912 and the Pecora Commission of 1932. The behaviour of exerting influence is a hallmark of the investment banking industry throughout its history.

4.2.15 Anthony Joseph Drexel – Railroad Bond Dealer and Global Banker

Figure 35 – Picture of Anthony Joseph Drexel



Source: (Drexel University c. 1880).

Another prominent investment banker of the era was Anthony Drexel who, born in 1826, began his career in his father's, Francis Drexel's firm, Drexel & Co., which was based in Philadelphia. Anthony Drexel was appointed a full partner in the firm in 1847 alongside his brother Frank. Under Francis Drexel the firm gained an early reputation as a currency broker which he established in 1838, the year after the financial panic. Once the Second Bank of the United States passed the role of distributing currency to the many state-chartered banks, many of which were unprepared to undertake this function, Drexel's business began

to flourish. The lack of liquidity in bank notes and the recovering US economy allowed Drexel to expand into railroad financing and convert his brokerage into a private bank. Under the guidance of their father, Anthony and his brother gained much experience in business affairs, and also developed an appreciation of the arts (Rottenberg 2001).

Within a decade, Anthony assumed the leadership role of the firm. Drexel concentrated on government bonds and railroad issues. As the demand for railroad financing increased, Drexel and Co. established an office in Chicago and New York. In 1871 the firm merged with the London based firm of George Peabody forming Drexel, Morgan & Co. (later J.P. Morgan & Co.). Drexel admitted John Pierpont Morgan as a junior partner at the urging of JP Morgan's father, Junius Morgan, whose own career had centred on bonds and stocks (Schweikart & Doti 1999, p. 102). The partnership with JP Morgan which was based in New York operated initially as an agent for European investors, gaining a large share of the transatlantic trade in railroad securities. The firm is also acknowledged as influential in developing a national market for the securities issues of industrial companies, other than railroad and canal companies (Rottenberg 2001). Drexel Morgan & Co. also assisted the US government through underwriting the wages of the US Army when the US government was unable to meet its obligations in 1877; again rescuing the US government during the Panic of 1895; and rescuing the New York Stock Exchange during the Panic of 1907 (Rottenberg 2001). These actions empowered Drexel, creating an enviable reputation in the business community and amongst fellow investment bankers.

Drexel's Power Found in the Facilitative Circuit

Drexel's power originated from his superior skill in arranging difficult financings, especially for government which created an image of Drexel as the 'go to man' in times of crisis. The assistance to government in difficult circumstances also created a sense of obligation amongst the government executive. Drexel's sense of self-importance and an example of his exercise of power is documented by an incident with President Ulysses S. Grant:

In a telling incident ... President Ulysses S. Grant once called on Drexel - and because Grant was five minutes late, Drexel made the President wait an entire hour before seeing him. President Grant, needing Drexel's bond selling expertise, was not insulted by the delay (Wooster 2002, p. 1).

This power exhibited by Drexel is found in Clegg's (1989) facilitative circuit. The exogenous environment of the financial crises of 1895 and 1907, combined with Drexel's technical skills differentiated Drexel from many of his compatriots. His technical skills enabled him to foster a bond market in the emerging corporate sector. In the process, given the substantial size of the issues, Drexel had to accurately assess the credit risk of the corporate borrowers, whose profiles were different to those of the railroads and canals. These differences required an astute judgement of risk for a diverse portfolio of customers insofar as the variety and non-

monopolistic nature of the industries were considered. Additionally the type of credit analysis required, focused on financial statements which reflected operational businesses relying on manufacturing and marketing to generate profits differing significantly to those of a transport concession. Drexel was also able to create a national bond market for industrial companies which required a network of like-minded investment banks and brokers capable of selling corporate bonds issued by a riskier class of borrower.

The knowledge Drexel developed led to the innovative solutions required to bailout the government from its abovementioned predicaments. His unique ability empowered Drexel in his social relations with key leaders in government and industry alike. These favourable key relations translated to a repeat of these successful transactions and therefore contribute to his and his firm's success. Drexel used his fortune and influence to establish the Drexel University in 1891 and was the first President of the Fairmount Park Art Association (now the Association for Public Art), the country's first private association dedicated to integrating public art and urban planning (Rottenberg 2001).

Apart from the influence Drexel acquired, he was also an innovator of practices which are routinely used today. "These include, trading of national currencies, guaranteeing credit for travellers abroad, rewarding workers based on individual initiative, and offering sweat equity to deserving employees who could not ordinarily buy shares" (Wooster 2002, p. 1). Two years after Drexel's death in 1893, Drexel Morgan & Co. was renamed J.P. Morgan & Co.

4.2.16 John Pierpont Morgan – 'The Most Powerful Private Citizen In The World'

Figure 36 - Portrait of John Pierpont Morgan



Source: (Lamb 1913).

John Pierpont Morgan (JP Morgan) was born in 1837 in Hartford, Connecticut, where he spent his formative years. He became one of the most influential investment bankers of his time and arguably in the history of investment banking in the US (Witzel 2003). He dominat-

ed corporate finance and industrial consolidation during the period 1871 until 1913 following the end of the Pujo Committee hearings (refer section 4.2.19 for a discussion on the Pujo Committee hearings).

His father, Junius Morgan worked as a partner in J. M. Beebe, Morgan & Co., a Boston, Massachusetts dry goods wholesaler, and in that role transferred to London as the company's representative. Junius Morgan encountered George Peabody in 1854 in London soon after arriving in London. Peabody also started his career as a dry goods merchant in Massachusetts and later became a financier. Peabody originally moved to London to develop his investment firm George Peabody & Co to support the funding of a railroad company he had previously incorporated in 1836, known as the Eastern Railroad, and to trade in bonds. Following his meeting with Peabody, Junius Morgan joined George Peabody & Co as a partner in 1854 and the name of the firm was changed to Peabody, Morgan & Co. 10 years later, in 1864. Upon the retirement of George Peabody, Junius Morgan succeeded Peabody as the head of the London operation and changed its name to J.S. Morgan & Co. (Schweikart & Doti 1999). The principal activities of the firm were the distribution of bonds, and during the Civil War, the firm increasingly focused on the sale of US war bonds (Chernow 1990).

In 1857, Junius employed his son, JP Morgan as a secretary in the count house and as the operator of the telegraph system to send out telegraphs to US War Bond investors of the outcomes of battles of the Civil War before it became general knowledge in England. Knowing the outcome of the battles before the investors, Junius was able to profit by trading the bonds whose value would fluctuate according to this important information (Schweikart & Doti 1999). In 1858, JP Morgan returned to New York to join Duncan, Sherman & Co. which was the US representative firm of the British merchant bank, George Peabody & Co.

From 1864 to 1871, JP Morgan worked in the firm of Dabney, Morgan, and Company alongside the Drexel brothers, he established the firm of Drexel, Morgan & Company in 1871. Apart from the significant influence of his father, JP Morgan was also mentored by Anthony J. Drexel at the request of Junius Morgan (Rottenberg 2001). This mentorship equipped JP Morgan with valuable skills relating to corporate restructuring which augured well for his corporate mergers and acquisition activities in the latter part of the 19th century (Rottenberg 2001).

After the death of Anthony Drexel in 1895, Drexel, Morgan & Company was renamed J.P. Morgan & Co. JP Morgan realised that in order to sustain business it was crucial to maintain and develop important relationships. He therefore continued to associate his firm with a sister firm, Drexel & Company of Philadelphia; and Morgan, Harjes & Company of Paris; and J.S. Morgan & Company (which in 1910 became known as Morgan, Grenfell & Company) of London. By the end of the 19th century, J.P. Morgan & Co. was considered one of the most influential investment banks globally, with focus on mergers and acquisitions, corporate restructuring and large financings (Chernow 1990). J.P. Morgan & Co. also became an employ-

er of choice within the investment banking industry and was therefore able to draw many influential partners to the firm (Morris 2015).

JP Morgan's power and influence was recognised by contemporary commentators. Examples of perceptions of JP Morgan can be found in the newspaper articles of the time. Mallios (2013, p. 1) recounts the words of a contemporary journalist who describes JP Morgan as "The most powerful private citizen in the world to-day, so far as financial affairs are concerned ..." (New York Tribune 1910). JP Morgan was also described as "the personification of a banking system: the most powerful private banking system in the US" (New York Tribune 1910). The Pujo Committee²⁰, which was mandated by the government to investigate the behaviour of the investment banks during the 1907 crisis, found that a small number of financial leaders, including JP Morgan, exercised considerable control over many industries (Brandeis 1932).

JP Morgan uses Power to Save the US Government

An example of JP Morgan's power occurred in 1895 when the US Federal Treasury had almost exhausted its gold reserves following the Panic of 1893²¹. JP Morgan had recommended that the federal government supplement its gold reserves through purchases from various banks in Europe as well as from his own firm, J.P. Morgan & Co. The federal government declined the plan and preferred instead to raise the necessary government funding to survive the crisis from a direct sale of bonds. Believing that the federal government was on the cusp of default, JP Morgan sought a meeting with US President Grover Cleveland, to express his concerns. JP Morgan came up with a plan to use an old Civil War statute that permitted the US Secretary of the Treasury to issue bonds without Congressional approval, for the purchase of gold coins from J.P. Morgan & Co. and the Rothschild family²² (JP Morgan Chase

²⁰ The Pujo Committee was a United States congressional subcommittee which was formed between May 1912 and January 1913 to investigate the so-called 'money trust', a community of Wall Street bankers and financiers that exerted powerful control over the nation's finances (Peeler 2010, p. 1). See section 4.2.19 for a detailed discussion on the Pujo Committee hearings.

²¹ The Panic of 1893 was a serious economic depression in the United States that began in that year. Similar to the Panic of 1873, this panic was characterised by over capacity in the railroad network and subsequent defaults in the industry which led to a number of bank failures.

²² The Rothschild family is a wealthy family who established a banking business in the 1760s and established an international banking network in London, Paris, Vienna, Naples and Frankfurt.

2016). President Cleveland sought a guarantee from JP Morgan that the gold would remain in the US and not to be diverted to Europe. JP Morgan agreed to the request and immediately arranged for a US government bond issue to be sold to his connections, the proceeds of which were used to purchase the gold and thereby restore liquidity to the US Treasury. “The firm offered the bonds for sale at \$112.25 and sold out the entire issue in New York within 22 minutes” (JP Morgan Chase 2016). Clegg’s (1989) Theory of Power is useful in analysing JP Morgan’s power in this example. The US Treasury’s dire need for gold reserves created an exogenous environment which required a solution – otherwise known in Clegg’s terminology as a ‘technology of production’ which is a source of power in the facilitative circuit. This need for a technical solution empowered JP Morgan in the facilitative circuit, as he was one of very few investment bankers with the resources and knowledge to provide an appropriate solution.

His knowledge of market appetite for bonds reflected the power of his relationships with other banks and investors. This power resided in his knowledge of investing appetite amongst the market participants which could only be gained through experience and an intimate knowledge arising from close relations. The relationships also permitted JP Morgan to ascertain the pricing level at which the bond appetite would become attractive to investors. The extent and quality of JP Morgan’s network of contacts was unrivalled in the market during this period. Further his innovative approach in solving the government’s needs which entailed an exchange of gold for bonds, fixed the rules within the dispositional circuit under which he would be willing to assist. This financing structure was the strict condition under which JP Morgan would assist the government. The strategy was very profitable for JP Morgan as it encompassed two tranches to the transaction. It ensured JP Morgan could earn commissions firstly from the bond sale process and secondly from profit margins on the gold purchase brokered for the government. Again the exogenous environment of the government funding dilemma gave it little choice given the lack of alternative remedies. JP Morgan achieved his desired outcome of selling gold to the US Treasury as he met all the criteria in Clegg’s (1989) episodic circuit: social relations through his professional network required to appeal to the ultimate decision maker in the country – US President, Grover Cleveland; the agency of his own firm and the Rothschild family through which he could implement the transaction; and the knowhow and financial resources to execute the transaction.

JP Morgan’s influence, particularly through the use of his personal and professional networks and knowhow relating to fundraising and corporate restructuring, empowered him to undertake many more successful transactions. This exercise of power using the same conduits of networks and knowhow was repeated by the investment banking industry in the pre-GFC period. In this latter period, investment banks were successful in lobbying legislators against a restrictive regulatory environment and against a prescriptive accounting standard for Repo 105 transactions. See section 8.2.2 for a detailed discussion on the in-

vestment banking industry's lobbying efforts towards legislators and accounting standard setters respectively.

As was shown above in this section, JP Morgan benefited substantially from effects of the Civil War through distributing Civil War bonds in London and the urgent replenishing of the US Treasury's gold reserves. Funding the Civil War effort offered impetus to the investment banking industry in general and apart from allowing bankers to further develop government funding techniques it presented them with further opportunities to exploit important government relationships.

4.2.17 American Civil War (1861 – 1865)

The origins of the Civil War emanated from the aversion to slavery by the US northern states of America (Union) which was adopted as a formal policy by the Republicans in 1860 upon the election of Abraham Lincoln as the US President. The southern states relied heavily on large scale agriculture and specifically cotton plantations which utilised large numbers of slaves as manual labour (Foote 2006). The southern states' objection to the moral attitudes of the northern states led to South Carolina seceding from the Union and this led other southern states to follow and form their own government, which, under the leadership of Jefferson Davis is referred to as the Confederate States of America (CSA) (Foote 2006; Killick 2006). The ensuing war was costly both in terms of loss of lives and financially for both sides. In all, the war resulted in 650,000 deaths and casualties of over a million (Foote 2006). Contributing to the heavy casualties were the more sophisticated military strategy and weaponry employed by both sides (Foote 2006).

Civil War Financing

Major differences existed between the Union and the CSA at the commencement of the Civil War. Apart from military capacity, these included the industrial and economic stage of the respective region's development and the level of financial support. The Union's institutional financial support consisted of a multi-tiered taxation stream of income and an established government Treasury which was able to manage a range of debt issues and print currency. In contrast, the CSA relied mostly on donations, meagre taxation revenue, printing of currency and a more modest level of debt issues. Although there were similarities in the types of revenue generation sources, the warring factions differed with regards to funding strategy and execution which led to varying effect and success. It was the raising of new debt where investment bankers and their special networks were most helpful to both sides especially when these networks extended overseas to Britain and continental Europe (Daggett 2010).

As indicated in Figure 37 the cost of the various wars in which the US participated varied widely. The cost of the Civil War far exceeded the cost of any other war in which the US had participated during that era.

Figure 37 - Military Costs of US Wars 1775 – 1900 (current and constant dollar values²³)

War in which The US Participated	Years of War Spending Total Military Cost of War (USD)
American Revolution	1775-1783
Current Year USD	101 million
Constant FY2011USD	2,407 million
War of 1812	1812-1815
Current Year USD	90 million
Constant FY2011USD	1,553 million
Mexican War	1846-1849
Current Year USD	71 million
Constant FY2011USD	2,376 million
Civil War: Union	1861-1865
Current Year USD	3,183 million
Constant FY2011USD	59,631 million
Civil War: Confederacy	1861-1865
Current Year USD	1,000 million
Constant FY2011USD	20,111 million
Spanish American War	1898-1899
Current Year USD	283 million
Constant FY2011USD	9,034 million

Source: (Daggett 2010, p. 1).

²³ Current dollar value is the value at the time the expense was incurred. Constant dollar value is the current dollar value adjusted for inflation to represent the value in 2011 terms.

The dollar amounts included in the above table represent estimates which are expressed in USD at the time of each conflict (Current Year) and in constant USD that reflect values as at 2011 for comparative purposes (Daggett 2010).

This data shows that whilst the Union had spent over USD 59 billion in 2011 equivalent dollars, the Confederation had spent a much lower USD 20 billion in 2011 equivalent dollars. In other words, “the Union expenditure represented about 65 per cent of 1861 gross domestic product (GDP)” (Giroux 2012, p. 83). The combined expenditure of almost USD 80 billion in 2011 equivalent dollars is by far the highest amount expended by Americans in any conflict during either the 18th or 19th centuries (Daggett 2010).

Union War Financing

In the early years of the Civil War funding was difficult for both sides. The Union Secretary of the Treasury Salmon Chase was conscious of earlier history such as the public fear and mistrust of taxing authorities and therefore was initially opposed to additional tax measures. The public fear of new tax measures emanated from the past experience of paying excessive taxes imposed by the British prior to the Revolution. Resentment against British taxes are often cited as a contributing cause to the Revolution. Additionally the public was wary of taxes generally given the resentment from certain quarters associated with the levying of excise taxes on spirits by the first federal government causing the Whiskey Rebellion²⁴. A Protracted war would require additional resources and revenues. This became a problem for Chase at the time as the major source of federal government revenue came from customs duties which provided USD 40 million in 1861 and represented a meagre fraction of the total revenue required (Giroux 2012, p. 83).

²⁴ The Whiskey Rebellion was the violent culmination of the opposition to the direct tax on Americans who produced whiskey and other alcohol spirits. In early 1791, to help pay off the national debt resulting from the Revolutionary War, Congress used its new constitutional authority to pass the first nationwide internal revenue law which was an excise tax on distilled spirits. Congress took this action at the urging of the first Secretary of the Treasury, Alexander Hamilton. All payments had to be made in cash to the Federal revenue officer appointed for the distiller's county. Resentment to the tax resulted in violent clashes between the rebels and the tax collectors and federal soldiers. In 1794, 150 rebels were arrested, all of whom were eventually pardoned (Hoover 2012).

Figure 38 – Portrait of Salmon Chase Secretary of the Treasury between 1861 and 1864



Source: (Carpenter 1861).

Given the burden of the financing requirement, the Union needed to develop new taxes and accordingly Congress passed the Revenue Act (1862) which enabled the introduction of new taxes. Not only did the new stable source of tax revenue assist in funding the war, it established an improved credit profile for the Union which was to become helpful in future borrowings, especially from overseas sources. As stated by Brownlee (1996, p. 23):

It was the nation's first modern war in the sense of creating enormous requirements for capital. Union war costs drove up government spending from less than 2 percent of the gross national (product) to an average 15 percent ... The capital requirements evoked a program of emergency taxation that was unprecedented in scale and scope.

Economist, Adam Smith recognised the critical balance between taxes and borrowings for wartime finance and acknowledged the fear associated with new taxes:

The ordinary expense of the greater part of modern governments in time of peace being equal or nearly equal to their ordinary revenue, when war comes they are both unwilling and unable to increase their revenue in proportion to the increase of their expense. They are unwilling for fear of offending the people, who, by so great and so sudden an increase of taxes, would soon be disgusted with the war; and they are unable from not well knowing what taxes would be sufficient to produce the revenue wanted. The facility of borrowing delivers them from the embarrassment which this fear and inability would otherwise occasion. By means of borrowing they are enabled, with a very moderate increase of taxes, to raise, from year to year, money sufficient for carrying on the war, and by the practice of perpetually funding they are enabled, with the smallest possible increase of taxes, to raise annually the largest possible sum of money (Smith 1776, p. 1080).

Chase was inexperienced in undertaking a large scale financing as required by the war effort. He realised that external assistance was necessary and sought assistance from Jay Cooke, a well-known investment banker to advise him on external borrowings and adminis-

ter the sale of war bonds. This method became the principle means of financing the war effort.

Figure 39 – Portrait of Jay Cooke, Financier to the Union.



Source: (Tax Analysts 2014).

Jay Cooke was born in 1821 and was another investment banker who mixed politics with banking. He was a member of Congress between 1831 and 1833 and worked for the firm E.W. Clarke & Co. before establishing his own firm in Philadelphia of Jay Cooke and Company (Ellis & Vertin 2003). Jay Cooke and Company had an enviable reputation as an influential investment bank, and was to prove invaluable to Chase as its “reputation among investors around the world enabled the bank to sell...bonds when other brokerages could not” (Snowden et al. 1909, p. 107).

The funding requirement in 1861 amounted to a historically high level for the federal government. According to reports from Chase to Congress in July 1861, the required financing amounted to “USD 320 million, with USD 80 million needed from taxes and the remainder from loans” (Thorndike 2001). Chase borrowed USD 150 million in 1861 from a consortium of New York banks. This loan was offered in gold and caused a drain on the gold reserves of many New York banks which consequently led them to reject the gold standard in December 1861 (Thorndike 2001). The new debt was deemed insufficient and the federal government proceeded to issue USD 150 million of paper currency (known as Greenbacks), pursuant to The Legal Tender Act of 1862. The currency was to serve two purposes: firstly it was a source of income needed by the government to service its debts; secondly it was an attempt to introduce liquidity to the economy to enable the investing public to purchase government bonds (Giroux 2002). The amount was subsequently increased to USD 450 million (Giroux 2002, p. 613). Features including identification numbers and signatures were designed to limit counterfeiting, a major weakness of similar bills, called Continentals, issued during the Revolution. A unique and important difference of the currency issued by the federal government to that issued by the CSA, was that it represented legal tender (Giroux

2002). This meant that the face value of currency notes was at all times available to extinguish personal debt to the government, such as taxes payable.

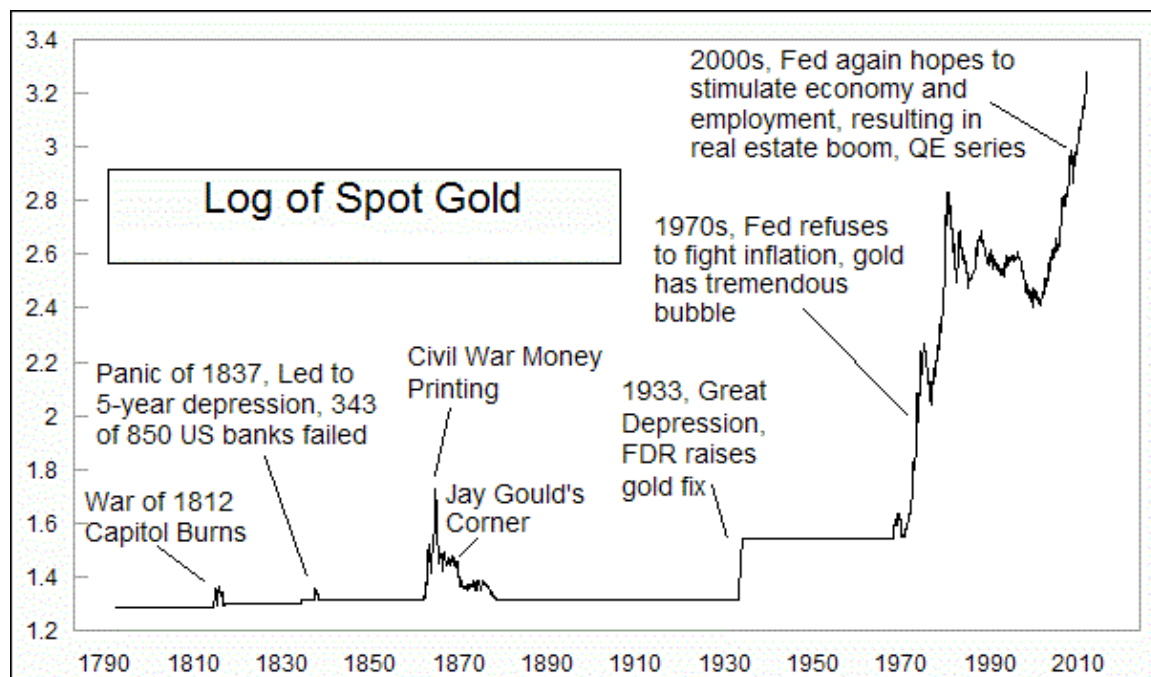
Figure 40 - Civil War Five dollar Greenback issued in March 1863



Source: (Tax Analysts 2014).

A cornerstone of the success of the Civil War financing by the Union was this level of innovation which was the result of collaboration between Chase and his investment banker associate, Cooke. The principle intention was to make the bonds attractive to investors. Having interest paid in gold created a windfall for investors as the value of gold had historically increased during times of war (refer Figure 41 for a graph of the gold price between 1790 and 2010) and given that the Union was planning to print additional currency it was expected the value of the Greenback would depreciate. Given the relatively short supply of gold, and that paper notes were not redeemable in gold, the public established a strong preference for gold as a means of exchange and the price of gold escalated whilst confidence in the currency notes declined during the period 1861 and 1879 (Giroux 2002).

Figure 41 - Log Price of Gold between 1790 and 2010



Source: (McClellan Financial Publications 2015).

Innovations were not limited to the structure of the bond issues, however also extended to their settlement. Cooke & Co's innovative use of the telegraph to confirm sales allowed selling throughout the country to be coordinated in Philadelphia (Geisst 2001, p. 37).

Chase therefore proceeded to sell USD 500 million in government war bonds (known as 5/20s) to pay for the war effort. The term 5/20s was an abbreviation for bonds that paid six percent interest (in gold) and matured in 20 years, but were callable in five years. Chase worked with Jay Cooke & Co. to successfully manage the issue in 1862 (Geisst 1999, p. 54).

Figure 42 - A One Thousand dollar 5/20 Bond featuring the face of Salmon Chase



Source: (Museum of American Finance 2014)

The cost of the war escalated, and by 1862, reached approximately USD 500 million (Giroux 2002). The war attracted significant unscrupulous contractors and corrupt government officials. Fraud was not uncommon. As stated by robber baron²⁵ Jim Fisk: "You can sell anything to the government at almost any price you've got the guts to ask" (McCullough 1981, p. 60). War expenditure rose to USD 1 billion in 1865 (Giroux 2012, p. 88). Chase and Cooke varied the debt instruments in order to attract the appetite of the broadest range of investor. These included individual bonds, serial bonds, which attracted different interest rates, Treasury notes, and certificates of deposits (Giroux 2012).

²⁵ Robber baron was a term applied to a businessman in the 19th century who engaged in unethical and monopolistic practices, wielded widespread political influence, and amassed enormous wealth.

Figure 43 - Article by Jay Cooke & Co. regarding distribution of the 5/20 Bonds

It is not generally known how large a proportion of the securities of the United States are held by people of moderate means for the investment of their savings. We have not at hand the precise figures of the denominations in which the several series of Five-twenties were issued, but the following statement shows the number of notes of each denomination embraced in the issue of the Seven-thirty Treasury notes, which are now being converted by the Treasury into Five-twenty bonds. In these conversions the Treasury has never been able to supply enough small bonds to adequately meet the demand:		
962,580	50s.....	\$48,129,000
1,474,940	100s.....	147,494,000
436,792	500s.....	219,896,000
370,376	1,000s.....	370,376,000
8,821	5,000s.....	44,106,000
<hr/>		
3,256,509	\$830,000,000
These figures will give an approximate idea of the amount in which all of the 5-20 bonds of the Government are held.		
They show that <i>one-half of the loan</i> in amount was taken in 50s, 100s and 500s, and further, that as 2,877,813 pieces of these three denominations were issued against 371,197 pieces of the large denominations, the capitalists are in very small minority, and any legislation repudiating, in whole or in part, the obligation of the bonds of the Government would fall most severely upon widows, orphans and people of small capital, who invested their money in those securities in perfect reliance upon the representations made to them by the Treasury Department, directly and through its agents at the time of their issue.		
More than once during the war, resolutions were offered in Congress looking to the payment of the 5-20s in currency, but in every case were promptly voted down. Yours, respectfully,		
JAY COOKE & CO.		

Source: (Cooke 1868)

The above *New York Times* article in Figure 43 conveys Cooke's argument that the 5/20 bonds were subscribed by many types of retail investors such as 'widows, orphans and people of small capital' as much as the wealthy capitalists. His argument is based on the records showing that 'one half of the loan in amount was taken in 50s, 100s and 500s' and further that as 2,877,813 pieces of these three denominations were issued against 371,197 pieces of the large denominations, the capitalists are in very small minority'. This record goes to support the argument that Cooke's distribution strategy was indeed successful at reaching a very broad investor base. The strategy was considered critical for such a large issue to suc-

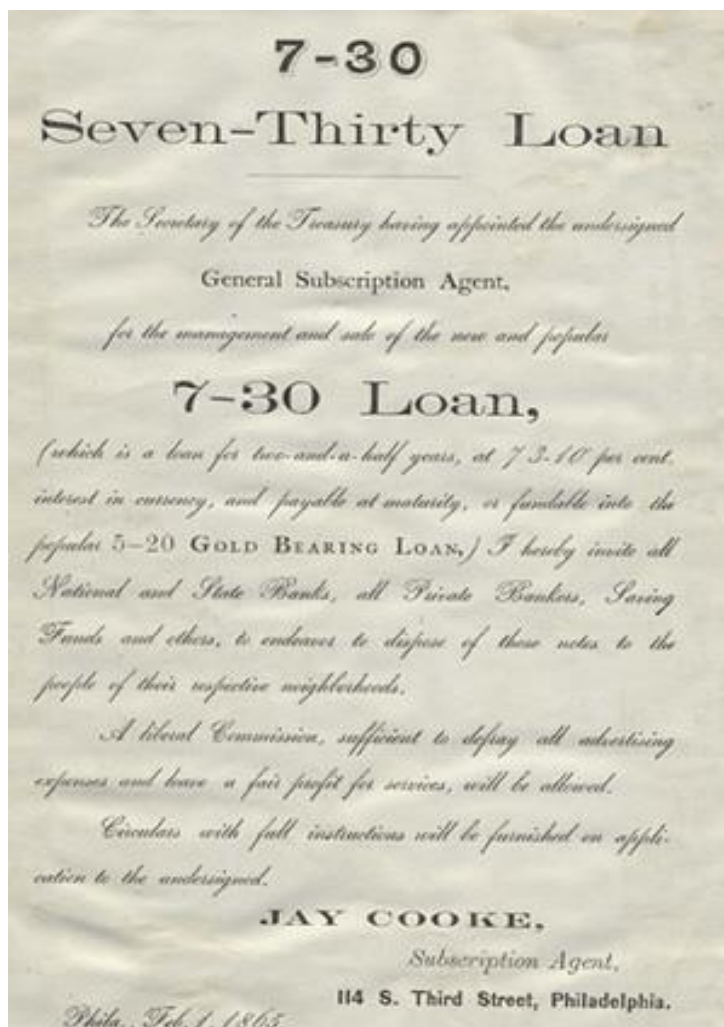
ceed and again proves the power of a well-executed and designed distribution strategy which is still considered an important attribute in any capital market issue in modern times.

The success of any bond distribution naturally relies on the effectiveness of reaching the investor. Many investment banking firms have therefore developed assertive sales cultures required to accommodate the necessity to sell bonds. The pressure of selling bonds is even more acute when the investment bank has itself underwritten them. Otherwise the unexpected residual risk of holding the remaining unsold bonds may be unacceptable and in some cases could place the firm in financial difficulty, either by imposing liquidity restrictions or leveraging the firm to unacceptable levels. The market risk associated with holding excessive levels of bonds are also problematic - particularly if the bonds decline in value. Given the risk of holding bonds with depreciating values, investment banks underwriting issues would apply a relatively deep discount to their price during the competitive bidding process. They would subsequently offload the bonds to the public and other financial institutions at a significant profit. "Underwriting syndicates would buy these at a discount and resell them to domestic and foreign bankers, usually at a substantial profit" (Gordon 1999, p. 94).

It was important for the government to support its own bond issues given its reliance on this form of financing. In an innovative move, the government introduced legislation, in the form of the National Banking Acts requiring "a third of a national bank's capital to be invested in federal bonds, since the new currency notes were to be backed by federal bonds" (Gordon 1999, p. 94). The federal government noted that the state banks which were subject to their respective state charters, were not bound by this federal regulation, and attempted to proportionally increase the number of national banks to state banks thereby creating a greater demand for federal government issued bonds (Comptroller of the Currency Administrator of National Banks 2003). To encourage the state banks to convert to national banks, the federal government imposed on the state banks a tax of 10% on the value of federal currency notes issued by state banks. By the end of the war, this new tax had the desired effect by quadrupling the number of US bond purchases and tripling the number of federal banks (Tax Analysts 2014). The imposition of this new legislation had two additional impacts for the banking community and government. It secured the value of the Union currency – being partly backed by government bonds, and induced demand for the government bonds which were critical to funding the war effort.

The large government bond issues required a new and innovative plan to reach new potential investors. Cooke devised a marketing campaign involving patriotic newspaper advertisements and a distribution network of 2,500 agents to sell the bonds. This campaign managed to sell USD 3 billion of government bonds to approximately twenty five percent of the population (Brands 2010; Tax Analysts 2014). Cooke's 'bond distribution' techniques have been copied by successive issuers aided by investment banks up to the present day.

Figure 44 - An announcement advertising 7-30 Bonds



Source: (Museum of American Finance 2015).

Apart from his thorough and effective distribution strategy, Cooke's greatest assistance was in the role of underwriting the bonds thereby guaranteeing part, or all, of the financing requirement under a particular issue. Although Cooke earned a relatively modest underwriting commission of 0.5%, he generated significant earnings from the high transaction volumes of his firm which generated profits from the deep discount mechanism mentioned above upon the sale to the public. The volumes were made possible by his innovative technique of using the telegraph to streamline settlement of the sales which resulted in sales of over USD 1 billion in Treasury bonds (Brands 2010, p. 80). Government bond issues were focused on the domestic market as there was little appetite from European investors. The federal government was represented in Britain by agents such as Joshua Bates and August Belmont, however only managed to sell approximately 10% of bonds to the European market, predominantly to German and Dutch investors (Sexton 2003).

Following the war in 1866, the federal government ran surpluses for almost 30 years (Giroux 2012, p. 95). Financing the war was not only a challenge for the North. It proved to be an even bigger one for the Confederate States of America (CSA) which, not being regarded internationally as an established nation, found it difficult to obtain funding from overseas sources or even by way of taxes.

Confederate War Financing

The CSA had a very difficult time financing its war effort. The Union blockade prevented the export of most of the South's cotton and other staple crops and stymied attempts to import specie (gold and silver coins) or other goods from abroad. Specie was therefore in short supply and tariff revenues were almost non-existent. The CSA, ostensibly founded on the principle of states' rights, found it politically unacceptable to raise, let alone collect, direct taxes. Tax revenues therefore accounted for less than 10% of the CSA's total receipts (Giroux 2012, p. 94).

Given the blockade, the region's short supply of specie, the uncertain outcome of the war, and its weak tax revenues, the CSA found it difficult to borrow domestically or abroad. Loans therefore accounted for only about a third of its wartime expenditures and much of its borrowing occurred early in the war, when a quick victory appeared possible. Individual states supported the Confederacy by paying for war expenses out of their own treasuries. In addition, churches, corporations, and private individuals donated money, food and clothing for the army. These donations continued throughout the war and increased especially during the final months of the conflict (Museum of American Financial History 1994, p. 16). On February 28, 1861, the Provisional Congress of the CSA authorized the first Confederate loan which became known as the 'Fifteen Million Loan'. Under its terms, CSA Treasury Secretary, Memminger was authorised to issue 15 million dollars-worth of bonds bearing eight percent interest, payable in 10 years and redeemable in five years at the option of the government by giving three months public notice (Museum of American Financial History 1994, p. 16).

Figure 45 - USD 1,000 Confederate Bond



Source: (Museum of American Financial History 1994, p. 16)

Similar to the Union, the CSA was also unsuccessful in raising loans in London where the default on several loans by some of the Southern states following the 1837 financial crisis tainted their credit risk profile with European financiers. However, the CSA was able to arrange a relatively small loan in Europe in 1863. The CSA Treasury attempted to use the cotton crop as collateral for securing this loan which was in the form of a bond issue. In 1862, John Slidell, the Confederate Commissioner to France, negotiated an agreement with Emile Erlanger and Co., a Parisian banking house, to manage the sale of a £3 million (USD 14,550,000) Confederate bond issue secured by cotton. This agreement became known as the Erlanger Loan. According to the terms of the loan, the twenty-year, seven percent bonds were to be converted into cotton below market prices. The Confederate government hoped that the chance of lucrative profits would lure European investors and restore the South's credit rating abroad. Erlanger proposed to pay £77 for every £100 bond the Confederacy offered, and then to offer the bonds to the public at £90, providing an immediate profit of £13 which is considered abnormally high given comparable bonds issued concurrently by the Union were often issued at par or with only minor discounts. When the bonds went on sale in March 1863 they were soon oversubscribed, but within a few weeks the price of the cotton bonds began to fall. Trading of the bonds was curtailed, although it did not stop completely. By February 1865, 83% of the bonds had been sold, and the CSA realised about USD 8,000,000 out of the initial USD 14,550,000 issue (Museum of American Financial History 1994, p. 18).

Although this money helped the South to acquire materials, it was not enough. The bonds became worthless when the South finally collapsed, but by that time Erlanger held no bonds (Lester 1974, p. 130). Given the deep discount on the bonds, the CSA paid a high price and appears to have been taken advantage of given the much reduced discounts paid by the Union bond issues. The key differences were that the CSA didn't possess the same sound credit

risk profile or the same level of collaboration or close-knit relationship with its foreign investment banking firm as did the Union with its domestic firm, Jay Cooke.

Sexton (2003) finds that the CSA implemented a flawed strategy in late 1861 by instituting an informal cotton embargo, hoping that this would increase the value of cotton. Instead the CSA should have considered shipping as much cotton as possible to European warehouses, where it could have been used as collateral for larger loans. Constrained by its limitations in the debt markets and tax revenue potential, the CSA resorted to printing currency to supply most of its financial resources. Similar to the Continental forces during the Revolution, state governments issued bills of credit which were used as currency while the CSA issued so-called 'Graybacks' analogous to Continentals.

Figure 46 - 10 dollar Confederate Currency²⁶



Source: (Museum of American Finance 2014)

Although similar in form and function to the North's Greenbacks, CSA currency was issued in sums far greater in proportion to the Southern economy than the Union's currency which was partly backed by Union bonds and considered "legal tender". Given the CSA's less sophisticated printing techniques, it suffered much more from counterfeit Graybacks than the north with its Greenbacks. The result of the rapidly expanding money supply was rampant

²⁶ The white dots in the image are unintentional.

inflation, second in American history only to the hyperinflation of the Revolution (Museum of American Finance 2014, p. 19). By 1863, it took 10 CSA dollars to purchase a gold dollar and by 1864, it took thirty. By early 1865 the price of a gold dollar was fifty or more CSA dollars. By contrast, it never took more than three Greenbacks to buy a gold dollar (Museum of American Finance 2014, p. 29).

The US investment banking industry clearly benefited from the fundraising activities of the North during the civil war conflict and much of this credit goes to Jay Cooke who collaborated effectively with the Union Treasury Secretary, Salmon Chase, to fund a majority of the Union war effort through the issuance of innovatively structured and well distributed bond issues. The clever use of taxation by the North also established a platform for its creditworthiness and no doubt engendered the confidence necessary amongst investors for any large scale bond issue.

On the other hand given the relatively smaller amount of debt raised by the South and the lack of evidence of close collaboration with the investment banking industry, the CSA were ultimately reliant on printing money which eventually caused severe economic and financial difficulties. The fact that the North was better able to fund its war efforts is often mentioned as a major contribution to its eventual victory. In addition Chase's willingness to closely engage the expertise of one of the best investment bankers in the country, in Jay Cooke, ultimately made a major difference in the outcome of the war.

The Civil War proved a challenge to the respective sides in finding new and innovative ways of seeking the necessary war financing. The newly united country was now left to focus on economic development. Following the Civil War, the manufacturing industry began to grow rapidly. For example sewing machines began being manufactured and the shoe industry became mechanised. Horse drawn reapers became widely introduced, significantly increasing the productivity of farming. The use of steam engines in manufacturing increased and steam power exceeded water power after the Civil War, while coal displaced wood as the major fuel. The combination of railroads, the telegraph, machinery and factories began to create an industrial economy (North 1982). This growth in the economy, which dovetailed an increase in exports of agricultural product to Europe, required an increased money supply which had the effect of raising the level of interest rates and placing pressure on the gold reserves held by the US Treasury. Consequently, an environment conducive to a financial crisis was produced.

4.2.18 The Panic of 1907

An analysis of the background to the Panic of 1907 is useful in understanding the context in which the investment banking community developed its influence over regulatory institutions and relationships with external parties. During the period of 1863 to 1913, the mone-

tary system in New York experienced significant volatility affecting both interest rates and liquidity of financial instruments. This market dynamic was caused by severe fluctuations of the volume of currency in the financial system caused by the seasonal export of cotton crops to Europe. As traders increased their trade finance facilities with banks which were used to pay for production costs, the supply of cash available in the local economy was depleted causing a seasonal spike in interest rates. When proceeds of the cotton exports were later received by growers, the increase in money supply resulted in lowering interest rates (Tallman & Moen 1990, p. 3). Furthermore the US exported USD 30 million in gold to London during the summer of 1907, which was an unusually high volume given the trading conditions (Tallman & Moen 1990, p. 4). As a result, the New York money market was left with an uncharacteristically low volume of gold upon entering the autumn season. New York financial markets were therefore squeezed by even less liquidity than usual.

The climax of the crisis of 1907 materialised in October when F. Augustus Heinze²⁷ attempted to take a majority stake in a mid-sized listed US corporation, United Copper Company. Heinz's plan to raise the share price backfired and the share price instead declined. Heinze had an extensive list of Board directorships including banks. As Heinze's involvement in banking became apparent, the failure of Heinze's scheme triggered a loss of confidence in the share market which was operating under the adverse conditions of a slowing economy, and a stretched money market. Depositors' fears of insolvency precipitated a series of runs on the banks where the two men held prominent positions including the popular Mercantile National Bank. Consequently a credit crisis characterised by a freeze on lending markets triggered a panic amongst banks which became known as the Panic of 1907.

²⁷ Fritz Augustus Heinze (December 5, 1869 - November 4, 1914) was one of the three 'Copper Kings' of Butte, Montana. He entered the banking business, forming a close alliance with Charles W. Morse with whom he served on at least six national banks, ten state banks, five trust companies and four insurance companies.

Figure 47 – Picture of Fritz Augustus Heinze



Source: (King 2012).

The New York Clearinghouse Association²⁸ reviewed the Mercantile National Bank balance sheet and concluded that the bank was solvent. The clearinghouse stated that it would support Mercantile on the condition that Heinze and his board of directors resign. Both Morse and E.R. Thomas, another of Heinze's cohorts, were persuaded by the clearinghouse to sell their investments in banks in return for the clearinghouse support of the affected bank (Gordon 1999).

Almost simultaneously, the National Bank of Commerce stopped accepting the cheques of the Knickerbocker Trust Company. The Knickerbocker Trust Company was a bank owned by Frederick G. Eldridge, an associate of JP Morgan. The main activities of the Knickerbocker Trust Company involved acting for individuals, corporations and estates (Wexler 1908). In 1907, its funds were being used by the bank's president Charles T. Barney in his plan to corner the market for copper and increase its price. This venture collapsed due to the dumping of millions of dollars in copper onto the market to prevent the abovementioned takeover of United Copper Company (Gordon 1999). On October 22 1907, Knickerbocker underwent a

²⁸ The New York Clearing House Association, the nation's first and largest bank clearing house, was created in 1853, and has played a variety of important roles in supporting the development of the banking system in the US's financial capital. Initially, it was created to simplify the chaotic settlement process among the banks of New York City. It later served to stabilise currency fluctuations and bolster the monetary system through recurring times of panic.

run and was finally suspended later that day. Following the publication on the next day of an article in the *New York Times* that Barney sat on the Board of Trust Company of America, the depositors' run spread to that bank. (Tallman & Moen 1990, p. 7).

JP Morgan was seen as a potential saviour to the financial community in the absence of a relevant regulatory authority. This position of informal responsibility was well documented in the press at the time (New York Times 1907; The Kingston Daily Freeman 1907). Even though JP Morgan and his cohorts refused to bailout the Knickerbocker Trust, *The New York Times* was still optimistic of the situation given the perception that JP Morgan was in charge. Following the meeting of the bankers, which decided the fate of the Knickerbocker Trust, *The New York Times* printed an article which commented as follows:

...It was the opinion of all the bankers at the conference that the general banking situation, not only as far as it concerned the banks, but the trust companies as well, has been very much strengthened, and no further trouble is apprehended. Such trust companies as may deserve assistance, it was learned, will receive it (New York Times 1907).

Although this optimism in a rescue by JP Morgan proved to be unwarranted, it nonetheless signalled the general public confidence in JP Morgan's power and means to resolve problems in the business community.

KNICKERBOCKER WILL NOT OPEN

Conference of Bankers Deems It
Unwise to Aid the Trust Com-
pany Further To-day.

EIGHT MILLIONS WITHDRAWN

Attorney General Jackson,
Though, Will Take No Step
to Close the Institution.

STILL HOPES FOR THE BEST

Results of Conferences After a Sus-
pension, a Brokers' Failure, and
Panicky Day in Wall Street.

What J. P. Morgan Said.

The closing of the bank, which some Directors still hoped up to a late hour last night was only temporary, although such hopes were entirely abandoned by other Directors, led to complete demoralization upon the Stock Exchange, where Mayer & Co. went down and prices crumbled without resistance under an avalanche of selling orders. It necessitated the formation of a big money pool by the leading Clearing House banks, helped out by the loaning of \$6,000,000 of Government money, brought Secretary of the Treasury Cortelyou hurriedly to this city, and led at once to conferences of Knickerbocker officers and the leading bankers of New York at Morgan & Co.'s offices, with Mr. Morgan presiding. The sole aim was to devise immediate plans to meet the situation thus created.

When Mr. Morgan left his office late in the evening at the close of this gathering he made this statement to the waiting reporters:

"We are doing everything we can, as fast as we can, but nothing has yet crystallized."

Asked whether any outside efforts were being made to enable the Knickerbocker Trust Company to resume Mr. Morgan said:

"I don't know anything about that; I am not talking about that."

Source: (New York Times 1907).

Figure 49 - The headquarters of the Knickerbocker Trust Company in 1905.



Source: (McKim et al. 1915).

The Panic of 1907 involved several types of financial intermediaries, each distinct, playing unique roles in the capital markets and operating under different sets of regulations. This regulatory framework created conditions that made a panic more likely than if regulation had allowed uniform access to all investment opportunities. The New York City trust companies, a group of financial intermediaries that had grown rapidly in prominence at the turn of the century, had experienced the most severe depositor run during the Panic of 1907 (Moen & Tallman 1992, p. 611). The run on the New York trust companies was preceded by a period of significant growth. Between 1897 and 1907, their assets had grown by 244% as compared to national bank assets which grew by 97% and state bank assets by 82% (Moen & Tallman 1992, p. 612). Trust company growth can be attributed largely to freer investment opportunities that resulted from being less subject to regulation than national or state banks. Although trust companies were profitable, the fact they specialised in collateralised loans was perceived as risky since these loans were to firms that could not obtain credit through national or state banks. This situation added to the severity of the panic (Chen et al. 2010).

The conditions that prevailed during the 1907 crisis appear similar to the conditions existing prior to the GFC. Both periods involved a significant growth of financial assets within the banking system, a relatively lax regulatory environment for non-bank financial institutions, an evolving framework for licensed bank supervision and a focus on low credit quality assets. Figure 50 outlines a timeline for the Panic of 1907 which exhibits similar characteristics to the lead up of the GFC. (Refer to CHAPTER 2 for a discussion relating to the lead up to the GFC).

Figure 50 - Timeline of the Panic of 1907.

Oct. 9, 1907	Failed attempt to manipulate share of United Copper.
Oct. 15, 1907	Shares start to tumble.
Oct. 21, 1907	National Bank of Commerce announcement that it would stop accepting cheques for the Knickerbocker Trust Company, triggering a run of depositors demanding their funds back and the eventual collapse of the Knickerbocker Trust Company.
Oct. 22, 1907	The start of the bank-run on the Knickerbocker Trust Company.
Oct. 24, 1907	J. P. Morgan arranged for a number of bankers to provide the then substantial sum of USD 23 million to allow the New York Stock Exchange to continue operating.
Nov. 2, 1907	Moore & Schley, a major brokerage firm, nears collapse because its loans were backed by the Tennessee Coal, Iron & Railroad Company (TC&I). Proposal is made for US Steel to purchase TC&I.
Nov. 4, 1907	President Roosevelt approves of the US Steel's acquisition of the (TC&I).

Source: (Chen et al. 2010).

A final problem afflicted the US financial system, one of perceptions and image. As New York replaced Philadelphia as the money centre of the nation, other regions started to fear the financial influence located in New York City, especially among the largest banks. People used phrases such as the 'House of Morgan' or the 'Money Power' to characterise New York's growing financial presence, frequently with the assertion that a 'conspiracy' to control the nation's money was directed from within the Boardrooms of the banks (Chen et al. 2010). A reflection of the public sentiment towards the 'Money Power' is depicted in Figure 51. The subtitle appearing on this editorial cartoon in *Puck* states: "The Central Bank - Why should Uncle Sam establish one, when Uncle Pierpont is already on the job?"

Figure 51 – Front Page of *Puck* magazine dated 2 February, 1910



Source: (Centre for History and Economics Harvard University 2010).

Each new panic resulted in a search for scapegoats. The fact that individuals such as JP Morgan had saved the US Treasury on occasion only tended to exaggerate the fears of a New York money conspiracy, especially during the Populist era²⁹. Consequently, when designing any new system, the banking reformers of the late nineteenth century inevitably sought to reduce New York's influence. That concern, along with efforts to address the need for a lender of last resort for the nation's banks (in place of JP Morgan), and centralise some of the banking functions in the US, played a key role in shaping the legislation that became the Federal Reserve Act of 1913. The Panic of 1907 caused over two thousand companies to fail but possibly the greatest impact was that it gave impetus to the US government to impose more federal regulation (Markham 2006, p. 146). The severity of the Panic of 1907 prompted a call for a commission to investigate the causes of the panic and suggest potential legislation to avoid future crises. This commission was known as the Pujo Committee (Miron 1986).

4.2.19 The Pujo Committee of 1913

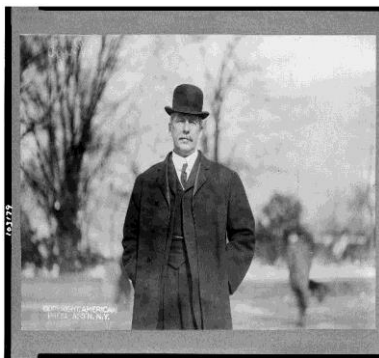
In November 1910, Senator Nelson Aldrich, of Rhode Island, charged with the task to propose regulations for the banking system, arranged to have five men meet in secret on Jekyll Island, Georgia, to design a new financial system for the nation. Frank Vanderlip of National City Bank, Paul Warburg a powerful partner in Kuhn, Loeb & Co., (later to be merged into LB), Henry Davison, a JP Morgan partner, and Harvard professor A. Piatt Andrew created a plan that provided the skeleton for the Federal Reserve System (Bruner & Carr 2007, p. 143). Their plan failed in Congress, partly because the concept was too centralised, and because it failed to address the problem of diminishing the power of New York. It became even clearer in 1912 that to succeed any plan had to deal with the issue of New York's influence.

Widespread cynicism spread as the public grew wary of the wealthy few in New York. Commentators observed that whilst JP Morgan's bank had survived, a large number of 'money trusts' failed. These commentators believed that the trust company failures (exacerbated by

²⁹ The Populist Movement was a politically oriented coalition of agrarian reformers in the Middle West and South that advocated a wide range of economic and political legislation in the late 19th century.

JP Morgan's refusal to support any of them) represented a conspiracy to advance the prospects of some New York based banks. Pressure from the public relating to their distrust of the 'money trust'³⁰ culminated in the formation of the Pujo Committee, which was a subcommittee of the House Committee on Banking and Currency (Schweikart & Doti 1999, p. 241). In 1912, Louisiana congressman Arsene P. Pujo, who was charged to lead the investigation on the 'money trust', called witnesses (including JP Morgan) and gathered more than 30,000 documents on the concentration of financial power among the nation's largest banks (Schweikart & Doti 1999, p. 241).

Figure 52 - Picture of Arsene P. Pujo



Source: (US Library of Congress c.1910).

The Power of the 'Money Trust' – and JP Morgan

The committee's investigation, spearheaded by Samuel Untermyer, a New York corporate lawyer who had become increasingly 'anti-big-business', tried to redefine 'trust' as a monopolistic cooperation by bankers (Schweikart & Doti 1999, pp. 241-2). Untermyer's questioning of JP Morgan produced testimony that frustrated critics of the 'big banks' and, indeed, of the entire business system. Untermyer asked Morgan if he favoured cooperation over competition. Morgan replied that he liked a combination, but "I do not object to competition, either. I like a little competition...." (Pujo 1913a, p. 1050). At that point Untermyer

³⁰ A 'money trust' is a concept that describes the capture of political power combined with vast wealth by a few influential individuals.

asked JP Morgan, “Is not commercial credit based primarily upon money or property?” To which the JP Morgan responded, “No, sir, the first thing is character....before money or anything else. Money cannot buy it... a man I do not trust could not get money from me on all the bonds in Christendom” (Pujo 1913a, p. 1084). This response indicated that credit decisions, in JP Morgan’s eyes, were principally subjective and dependent on the quality of character as perceived by the credit provider. Therefore the response itself underlines JP Morgan’s belief that his own judgement was sufficient to either grant or deny a loan thereby empowering the credit provider by subjugating the loan applicant to the personal judgement of the credit provider.

In another statement during the Pujo Committee hearings in 1912, Morgan likened his own personal financial welfare with “the best interests of the country” (Mallios 2013, p. 3). This comment accurately captures the nationalistic frame of JP Morgan’s view of himself. He considered his interests on a national level rather than on a familial, local or even state level, thereby suggesting a sense of self-importance and with that notion, an ownership of power and influence. Whether his view was justified, JP Morgan’s business interests were indeed national and moreover international, and JP Morgan himself had recognised his sphere of influence. In addition to his own sense of self-importance, a depiction of JP Morgan as “the most powerful private citizen in the world” (Mallios 2013, p. 3) had been in circulation in the US since at least 1902 (Mallios 2013). Therefore if the public at large believed this characterisation of JP Morgan, then his influence would be perceived as significant.

One of the lasting findings of the Pujo Committee which resonates following the recent GFC and which is explored further in this thesis is the notion of concentrated power and influence through networks within industry and with the regulatory and governmental fraternity. The Pujo Committee found the concentration of wealth in the country through directorships, share ownership, and holding companies was worse than critics had alleged. The Pujo Committee found that 22 percent of the total banking resources of the nation was concentrated in banks and trust companies based in New York City (Foster & Holleman 2010, p. 3). For example, George F. Baker, the Chairman of First National Bank of New York, held 58 directorships in 1912. The Committee published information showing the lines of financial ownership and control, focusing particularly on JP Morgan's far reaching financial and industrial empire, highlighting chains of interlocking directorships through which such control was exercised. It identified an ‘inner group’ associated with the trio of JP Morgan, George F. Baker from the First National Bank, and James Stillman from National City Bank, as well as the various other banks and firms they controlled. Collectively, the inner group held three hundred directorships in over one hundred corporations. The Pujo Committee claimed that it was not investment but rather control over US finance and industry that was the object of the extensive web of holdings and directorships (Foster & Holleman 2010, p. 3). It concluded that there was:

...an established and well-defined identity and community of interest between a few leaders of finance, created and held together through share ownership, interlocking directorates, partnership and joint account transactions, and other forms of domination over banks, trust companies, railroads, and public-service and industrial corporations, which has resulted in great and rapidly growing concentration of the control of money and credit in the hands of these few men (Pujo 1913b, p. 129).

There was an irony to the Pujo hearings. Through the clearinghouse systems which represented the abovementioned 'close community', the nation's banks had taken important steps to reduce the likelihood and severity of financial disruptions. As it happened, the most crucial tool in defusing panic was the cooperation and collaboration of the major banks in the absence of a governmental body or central bank. In essence, Untermeyer attacked the bankers for protecting depositors. However it was the public resentment over the power wielded by these few individuals in times of crisis without independent consultation that was at issue. The same power that alleviated the panic could also be used for profiteering, common in any monopolistic, or to a lesser extent oligopolistic, system. This period of the early 20th century was the time when investment bankers launched the new era of monopoly capital. Consequently, according to Hilferding (1910), the investment banks generated excess returns otherwise known as 'promoter's profits'.

One of the most critical indictments of the investment banking industry following the findings of the Pujo Committee was elucidated by Brandeis (1932) who, eloquently provided an unflattering description of the investment banker and highlighted the dangers of granting important government functions such as those of a central bank to private industry participants:

The dominant element in our financial oligarchy is the investment banker. Associated banks, trust companies and life insurance companies are his tools ... The development of our financial oligarchy followed...lines with which the history of political despotism has familiarized us: usurpation proceeding by gradual encroachment rather than violent acts, subtle and often long-concealed concentration of distinct functions which are beneficent when separately administered and dangerous only when combined in the same persons...The makers of our own Constitution had in mind like dangers to our political liberty when they provided so carefully for the separation of governmental powers. (Brandeis 1932, p. 6).

Although Arsene P. Pujo left Congress in 1913, the findings of the committee inspired public support for ratification of the Sixteenth Amendment in 1913³¹, passage of the Federal Reserve Act³² that same year, and passage of the Clayton Antitrust Act³³ in 1914. As a mark of irony in the first half of the 20th century, the undesirable themes that were prosecuted by the Pujo Committee consisted of conflict of interests, concentrated power through collaboration and anti-competitive behaviour, were in stark contrast to those supported by Ferdinand Pecora, as counsel for the Senate Committee on Banking and Currency in the 1930s. “Pecora effectively blamed the competitiveness of the securities industry for the ‘evils’ that beset the market during the late 1920s” (Schweikart & Doti 1999, pp. 240-2).

The new era of monopoly capital spurred an expansion in the banking industry in the early 20th century. By the 1920s, the ‘money trusts’ had reached a new peak of influence and commercial banks facing greater competition sought new avenues for profit generation. These areas included dealing in equities and some activities which were previously the traditional reserve of the investment banking industry. The consequent expansion of available funds for investment created asset bubbles which were to culminate in the stock market crash of 1929. The following section discusses the Great Depression and the new wave of regulation that followed.

³¹ The Sixteenth Amendment to the US Constitution permitted the US government to directly tax income on a national basis, without allocating it to the states.

³² The Federal Reserve Act (1913) established the Federal Reserve System as the country’s central banking framework and allowed it to issue legal tender in the form of the US dollar.

³³ Clayton Antitrust Act addressed anti-competitive behaviour which could potentially cause harm to consumers.

4.3 Post-Depression Regulation Brings a Shift in Power

4.3.1 The Great Depression and New Regulation

The massive sale of bonds to finance WWI brought many new players into the securities markets. Banks were expected to help the war effort by lending investors the funds to purchase war bonds on favourable terms. The banks did so in large numbers by expanding their bond departments or forming new securities affiliates. By 1922, 62 commercial banks were directly engaged in investment banking, and another 10 had launched securities affiliates (Neely 1995). The growth of the financial sector following the prosperous period post-WWI was driven by an emergent middle class and consequent growth in individual wealth. This economic progression also spurred interest in stock market investments. Commercial bank involvement in investment banking continued to grow in the 1920s. This was due to three major factors including: a reduction in corporate loan demand, caused by an increasing use of equity funding; the issuance of long-term corporate debt securities directly to investors thus bypassing the intermediary role of the commercial banks, a concept known as disintermediation; and large cash flows flowing from a prosperous economic period that eliminated the need for borrowing by many companies. Consequently, commercial banks needed to search for alternative sources of income. Many large banks, buoyed by a rising stock market and other factors, chose investment banking to fill that profit void. Between 1927 and 1930, commercial banks' share of the new bond issuance participation market rose from 37 percent to 61 percent (Neely 1995).

Throughout the three decades up to 1929, the investment banking industry thrived and continued to be dominated by the 'money trust'. The industry was "still dominated by an oligopoly that consisted of J.P. Morgan & Co.; Kuhn, Loeb & Co. (later to be absorbed into LB); Brown Brothers; and Kidder, Peabody & Co" (Stowell 2010, p. 22). The transactions in which they participated lacked transparency and during activities such as initial public offerings, corporate restructures or mergers and acquisitions in which they were involved, there was little consideration for other stakeholders (Stowell 2010). This period represented a fertile environment for public equity issues. Due to a burgeoning equity market between 1926 to 1929 the popularity of bond issues was usurped by equity issues which increased from USD 0.6 billion to USD 4.4 billion (Stowell 2010, p. 22). Whether the corporate market was favouring bonds or shares as a fundraising technique was inconsequential to the investment banks as they were dominant in both and rode the wave of growth regardless. By 1930 commercial banks and their securities affiliates were the principal players in the investment banking industry. Commercial and investment banking had effectively merged into a one stop shop, without a complete official sanction (Neely 1995). At this time there had been no

legislation requiring the separation of commercial bank activities from those carried out by investment banks. Therefore to supplement their income, many commercial banks undertook riskier investment bank activities. It was not uncommon for commercial banks to use their funding sources, such as customer deposits to finance their riskier activities such as underwriting of securities' issues and share trading. As a principal objective of bank capital is to provide a buffer against potential losses, the riskier the banks' activities, the greater the potential losses and the higher level of capital required. Fortunately the banks were mostly incorporated and therefore able to issue equity to the public to augment their capital reserves as required. This capital fuelled the dramatic expansion in investment banking as growth was not simply limited by partners' capital.

The escalating prices of listed companies created an unsustainable bubble which finally burst in 1929 with the collapse of the stock market. During the Great Depression that followed the capital available to the banks was insufficient to support the risks incurred from their investment banking transactions. This was a major contribution to the various bank failures (Benston 1990). The reformers were concerned about the power of the investment banking community and these concerns were crystallised in the form of a series of hearings in 1932, known as the Pecora hearings (Pecora was the eventual Chief Counsel of the Congressional Committee that staged the hearings). Although the hearings found no evidence of outright fraud, they discovered that JP Morgan's partners paid virtually no taxes in the recent preceding period and that one of JP Morgan's banks, National City Bank, had a 'preferred list' of clients who received preferential allocations and prices for new corporate stock issuances. This activity was considered contrary to the public interest however no action was taken.

By 1933, the US banking system entered a period characterised by fear, uncertainty, high levels of bad debts and a liquidity freeze which caused it to grind to a halt. Immediate action was required by the incumbent government led by President Roosevelt which undertook a series of reforms to address the malfunctioning banking system, the economic malaise and inadequate consumer protection legislation. The ensuing key legislation included: the Glass Steagall Act of 1933; The Securities Act of 1933; The Banking Act of 1933; The Securities Exchange Act of 1934; The US Bankruptcy Act of 1938; and The Investment Company Act of 1940. A brief overview of this legislation follows.

4.3.2 The Glass–Steagall Act of 1933 (GSA)

One of the major outcomes of the Pecora hearings led to a reduction of the power and influence held by the joint commercial bank and investment bank conglomerates. The enactment of the GSA in 1933 was in response to the demise of the banking system during the Great Depression (Crawford 2011). In recognition of the additional risks commercial banks

incurred in their investment banking activities, the GSA required the legal separation of bank activities from investment bank activities. For example, J.P. Morgan divided its operations into three entities: J.P. Morgan, which continued as a bank; Morgan Stanley which operated the US investment banking activities; and Morgan Grenfell, which operated the British merchant banking business. Almost immediately upon enactment, the financial community spearheaded by the banking/investment banking industry, lobbied to have the GSA repealed. Over the years, this persistent lobbying led to a continual reinterpretation and liberalisation of the GSA, until the Act was repealed in 1999 (Crawford 2011). Just prior to the repeal, Senator Paul Wellstone prophetically stated his misgivings regarding the proposed repeal in the Senate:

He said the repeal of Glass-Steagall would enable the creation of financial conglomerates which would be too big to fail. Furthermore, he believed that the regulatory structure would not be able to monitor the activities of these financial conglomerates and they would eventually fail due to engaging in excessively risky financial transactions. Ultimately, he said, prophetically, that the taxpayers would be forced to bail out these too-big-to-fail financial institutions (Crawford 2011, p. 127).

4.3.3 The Securities Act of 1933.

The Securities Act of 1933, “required that any offer or sale of securities using the means and instrumentalities of interstate commerce be registered pursuant to the 1933 Act, unless an exemption from registration exists under the law” (Sarkar 2014). The Securities Act was Congress' initial attempt to stem securities fraud, primarily targeting the issuers of securities and those firms selling the securities, such as investment banks. Issuers have an incentive to present the company and its plans in the most favourable light possible in order to engender appetite for their issues. To protect investors, the Securities Act serves the dual purpose of ensuring that issuers selling securities to the public disclose material information to investors, and that any securities transactions are not based on fraudulent information or practices. In this context, ‘material’ means information that would affect a reasonable investor's evaluation of the company's stock. The goal was to provide investors with accurate information enabling informed investment decisions (Sarkar 2014). Prior to the Securities Act, the states were responsible for the regulation of securities transactions. These laws were

referred to as 'Blue Sky Laws'³⁴. The Securities Act initially co-existed with the various state laws partly due to a view that new federal law was unconstitutional (Sarkar 2014).

4.3.4 The Banking Act of 1933

The Banking Act of 1933 also attempted to level the playing field between the big businesses of the large investment and commercial banks and the smaller local banks by instituting a depositor insurance scheme. The scheme protected depositors up to USD 100,000, and therefore enabled the smaller banks to compete for deposits with their larger competitors. Consequently the risks of bank failure were equalised between the two segments of the market (Skeel 2005a, p. 96).

4.3.5 The Securities Exchange Act of 1934

Following the enactment of the Securities Act of 1933, which covered the primary trading of securities, the government needed to address the secondary trading of securities such as bonds, shares and debentures. This was effected by The Securities Exchange Act of 1934 which established The Securities and Exchange Commission (SEC) - the institution primarily responsible for the effective and fair trading of securities in the US and which has survived to the present day (Morrison & Wilhelm 2007).

4.3.6 US Bankruptcy Act of 1938

Under the New Deal, a series of economic and regulatory reforms initiated by President Roosevelt to stimulate the US economy after the Great Depression, the power of investment banks was further curtailed significantly. In particular, the enactment of the US Bankruptcy Act of 1938, known as the Chandler Act, eliminated the equity receivership technique that J.P. Morgan had used to restructure many of the country's railroads and large corporations. Investment banks would no longer control the process, instead a court appointed trustee would take charge of any large corporation that filed for bankruptcy. Further, the

³⁴ The state based 'Blue Sky Laws' were established to control securities fraud by requiring corporations to register all new securities issues whilst providing all information related to making an informed purchase decision. One of the problems with these laws were that they varied between states and the federal government sought to unify the disparate legislation under one authority (West's Encyclopedia of American Law 2008).

Trust Indenture Act of 1939, prohibited corporations from issuing bonds that could be restructured by a bondholder's vote. This made it difficult for investment bankers who underwrote bond issues to manipulate and control a restructuring outside of bankruptcy (Skeel 2005a, p. 96).

4.3.7 The Investment Company Act of 1940

The Investment Company Act of 1940 defined an investment company and delineated the activities of investment companies such as mutual funds and investment banks. Furthermore, it established a limit on the number of investment bankers able to sit on the Board of an investment company and set strict criteria on transactions between investment companies and investment banks. Again, this Act reflected an attempt to curtail the breadth of the activities undertaken by investment banks and thereby limit their potential influence over the financial economy.

4.3.8 New Regulations a Catalyst for a Shift of Power

The new legislation had the effect of transferring some powers to the regulators. The highly prescriptive nature of the new regulations restricted the operations of investment bankers and curtailed the freedoms they once enjoyed. Consideration of reputation became less relevant an issue in the solving of corporate problems by investment banks who were used to exercising a degree of discretion before acting to solve a crisis or to entertain a transaction for example (Morrison & Wilhelm 2007).

Within Clegg's (1989) framework of power, the series of successive restrictive legislation represented a new operational environment for the investment banks. Clegg's (1989) exogenous environment, has the potential to redefine or refix the relations between the regulator and the regulated. Where once, investment banks were able to dictate their own terms, they were now compelled to comply with a strict set of rules, which affected their day to day activities. The laissez-faire exogenous environment had changed. This change clearly established which parties were subjected to control and which could exercise dominance. The dynamics of this shift which refixed relations between the regulator and the investment banks are found in Clegg's (1989) facilitative circuit. The obligatory passage point through which this shift of power is transmitted is represented by the compliance process where the power is transmitted to the episodic circuit. In this circuit the day to day activities of the investment banks changed and were subjugated to the wishes and oversight of the newly empowered regulators. From a wider perspective the new interventionist approach advocated by President Roosevelt represented a backlash over decades of public mistrust of the 'money trust' and big businesses which operated without transparency in the pursuit of abnormally high profits. The foreshadowed shift in influence from the powerful elite to a government sponsored regulatory framework was prophetically expressed in 1905 by the New

York Superintendent of Insurance who desired “elimination of Wall Street control” (Morrison & Wilhelm 2007, p. 13).

Pre WW2 the investment banking community was investigated by a number of Congressional committees and the industry’s ability to influence the environment to generate favourable outcomes became increasingly constrained (Morrison & Wilhelm 2007). The post-depression backlash of heightened regulation new to the industry and the general distrust of participants continued to pervade the public, political and regulatory spheres throughout the 1940s and 1950s. A good reputation, traditionally a core asset of a firm, was hard to re-establish and protect. The focus on regulation was to diminish in the years following WW2 due to the failure of an anti-trust case brought by the US Justice Department against a group of investment banking firms. The world economy grew during this period and as usual following such growth so did the fortunes of the investment banking industry. This modern era brought with it new challenges for the industry such as: the diminishing importance of tacit skill; a simultaneous reduction in the importance of reputation; a period of innovation and technological advancement; the problem of staff mobility; the need for new capital to fund an expanding corporate sector; and increased competition from the commercial banking sector.

4.4 Post World War Two (WW2) Transformation

This section deals with the transformation of the investment banking industry in the post war years. Discussion will focus on the trend for partnerships to incorporate in an effort to seek additional capital from shareholders which was needed to support: a growing business base; an escalation in risk taking activities; and the required investment in costly information technology. Additionally the swing back to a liberal approach in regulatory reform post-1950 is analysed and found to be reactive in nature. The consequences of this transformation produced a corporate approach to the investment banking business which relied less on tacit skill and reputation. This led to a less personal approach to business where physical distribution capacity overtook tacit skill as a key differentiator at a time when the business model evolved from an advisory focused enterprise to a model that placed greater emphasis on securities trading. The trend to incorporate also led to an increase in staff mobility and a restructure in senior executive remuneration arrangements which promoted higher risk taking business activities.

The role of power is analysed in this section from two perspectives. Firstly, the role of power is investigated to explain the industry’s influence in 1953 in defeating the US government in

a landmark court case which set the scene for the ensuing 'light touch' period of regulatory reform. Secondly, an attempt is made to understand the changing nature of the source of power from one relying on tacit skill of key personnel to a more hierarchical management structure where the power of the CEO replaced the democratic style decision-making typical of a partnership. Additionally, this section suggests that the trend to incorporate was influenced by mimetic isomorphism whereby the safe option of competing in an industry facing the challenges of a tough economic climate was to replicate the business model of other firms which were perceived as successful.

The post WW2 era signalled a reversal in the regulatory approach towards the investment banking industry. This was likely driven by the economic circumstances of the time which required a stimulus following many years where industrial production was dedicated to the war effort. Focus in the new post war era was directed towards the commercial sectors of the economy including the technological improvements which spurred demand in consumer and industrial production. The capital investment required was to be met by financial institutions and investors in general and the investment banking industry was seen as an important source of this capital. Too much regulation in this period was seen to interfere with this buoyant economic environment. However the legacy of the anti-investment bank sentiments prevailing during the earlier part of the 20th century persisted in certain government circles. The US government attempted to challenge the investment banking industry in a 1950 court case by claiming seventeen firms were guilty of anti-competitive behaviour from 1915 onwards. The complaint was summarised by the prevailing judge as:

Beginning in or about the year 1915 and continuing thereafter up to and including the date of the filing of this complaint, the defendants named herein, have engaged, knowingly and continuously, in a wrongful and unlawful conspiracy to restrain unreasonably and to monopolize the securities business of the United States ... all in restraint and in monopolization of the interstate commerce described in this complaint ... (Whitney 1955, p. 325).

An example of unconscionable and uncompetitive behaviour involved Kuhn Loeb & Co, a firm (which was ultimately merged into LB), cited by Whitney (1955, pp. 323-4), which in 1945 was accused of having removed a client's securities issue from the market simply because the client had requested a lower underwriting commission. This case, known as the 'Investment Bankers case' lasted for three years until 1953 when the court decided against the government by concluding that the 17 investment banks brought to trial were innocent of any wrongdoing (Whitney 1955). In dismissing the government's case, the judge, Harold R. Medina, stated that "The government case depends entirely upon circumstantial evidence" (Medina 1954, p. 9). Further, the judge concluded that even though the evidence suggested that investment bankers had attempted to collude in the earlier part of the century as a consequence of cultural practice, recent statistical evidence contradicted the US government's allegations (Whitney 1955).

However it is interesting to note that the statistical evidence was supplied by the investment bankers themselves, suggesting a possibility of them providing filtered and biased statistics in support of their case. The success of the investment banking community reflected their power in resisting the might of the US government's resources in prosecuting the case. The group of investment banks had matched the government's legal teams which would have required significant financial resources given the longevity of the court proceedings.

Financial Resources as a Means to Power in the Episodic Circuit

This example of power exerted by the investment banking group rests on the might of their financial resources which facilitated an effective defence. The adversarial social relations with government created a legal conflict where only one party could win. The probability of success was partly reliant on the quality of the case presented which was partly influenced by the quality of the legal defence team. It is assumed that given the gravity of the case and the dire consequences for key players such as J.P. Morgan, an expensive team of lawyers was engaged for the defence. Through the agency of the legal team and the resources applied, which constitute a 'means' within the Clegg's (1989) episodic circuit, the investment banks were able to generate a positive verdict.

4.4.1 The Empowering Role of 'Reputation' in the Pre-1950s

The idea that the investment banks were involved in a conspiracy to prevent competition failed to include the role of reputation as a natural barrier to entry. The importance of reputation as a concept in the survival and success of investment banks and as an obstacle to new entrants attempting to establish a foothold may not have been fully understood by the government in the post war era. The seemingly strong grip on the investment banking business by existing participants had become the instigator for the government case. The government's decision to undertake legal action was also fuelled by strong public opinion and distrust of investment bankers (Morrison & Wilhelm 2007). These bankers, many of whom were perceived as a privileged class exhibiting the usual trappings of wealth, presided over the sale of securities to unsuspecting investors, the value of which were to drop dramatically in the aftermath of the 1929 stock market crash and contribute to widespread distress during the Great Depression. Therefore they seemed a suitable scapegoat for the government and the wider population (Morrison & Wilhelm 2007).

Reputation was an important element in the ability of investment banks to attract clients. The more observable the historic success of an investment bank, the greater the potential to grow reputation. An investment bank's success is due to the skill of the bankers and the techniques applied in each transaction. (Whitney 1955) suggests that in addition to skill and knowhow, investment bankers develop a reputation based on initiative and enterprise: "Es-

entially, an investment banking firm is a combination of men of two different kinds - men with capital and men with a great deal of initiative and enterprise” (Whitney 1955, p. 322).

As clients’ problems are solved or needs met, the investment banks develop an intellectual capital which can be used for subsequent transactions. The power enabling techniques and innovation necessary in producing a market leading reputation is found within Clegg’s (1989) facilitative circuit. The resultant power is influential in positively affecting the firm’s reputation with clients leading to close and fruitful social relations. The positive social relations which operate in a cycle between the facilitative circuit and the episodic circuit impacts on the future successful business outcomes of the firm as subsequent transactions ensue. The success of the investment banking industry in proving an absence of anti-competitive behaviour, in part provided justification for a liberal approach to future regulatory impositions.

As the US requirement for post WW2 capital increased, the investment banking industry needed to address their ability to meet the associated funding demands. These demands not only included funds from their own balance sheets (which would prove insufficient), but also from public investors. To facilitate the flows of capital from investors to the industrial corporate sector, the investment banks needed to enhance their distribution networks and retail businesses. The greater emphasis on retail brokerage was supported by improvements in technology and coincided with a reduction in reliance on tacit skills largely required by the advisory departments, as this side of the business became relatively less important. The associated expansion of the investment banks’ business re-introduced a requirement for further capital which instigated a re-assessment of the investment banking model, and spurred a trend towards incorporation.

4.4.2 Transformation from Partnership to Corporation

The business model of investment banks up until the immediate post WW2 period largely comprised the partnership business structure (Geisst 2001). The ability of this structure to generate additional capital was limited to the capacity of the partners to inject additional funds or introduce new partners. As existing partners were generally reluctant to dilute their ownership in the firms, they sought an alternative business structure and resorted to

incorporation. According to Securities Industry and Financial Markets Association (2013), “The CPI-adjusted capitalisation of the top 10 investment banks soared from USD 1 billion in 1960 to USD 194 billion in 2000”. This expansion coincided with an increase in the number of banking professionals³⁵ employed by the top five investment banks (ranked by capitalisation) from 56,000 to 205,000 between 1979 and 2000 (Securities Industry and Financial Markets Association 2013). Apart from a general increase in economic and financial market activity, this expansion in capitalisation and employee numbers was caused by a significant shift from the partnership form of business entity to the corporate form.

The major firms which had substantial wholesale trading and brokerage activities and proceeded to list on the stock exchange included: Donaldson, Lufkin & Jenrette (1970); Merrill Lynch (1971); Reynolds Securities (1971); Bache & Co (1971); Lehman Brothers (via the acquisition by American Express in 1984, and later independently in 1999); Bear Stearns (1985); Morgan Stanley (1986); and Goldman Sachs (1999) (Morrison & Wilhelm 2007, p. 50; Schellhorn 2011, p. 113). (Gross 2010, p. 1) argues that it was inevitable for investment banks to seek public listing since, “In order to have a capital base that would support the funding they needed, they had to be public”. This transformation was largely driven by a reduction in the reliance on tacit skill, a potential for corporate executives to maximise their executive compensation through incentive schemes, an increasing emergence of the power of information technology and the need for risk capital.

According to Morrison and Wilhelm (2007, p. 46), the constant objective of the investment banker, “is to enforce private laws that support the exchange of critical information”. This requires “network and reputation management as the two core competencies that support this mission” (Morrison & Wilhelm 2007, p. 46). As networks are driven by social interaction and reputation is governed by personal decision-making and action, the implication for the role of an investment banker is that personal qualities including appropriate behaviour are important elements to the attainment of these attributes. It is difficult to learn such qualitative characteristics from technical training. Instead these skills have been historically passed on through mentoring and supervision by superiors representing tacit skills as opposed to codifiable skills (Morrison & Wilhelm 2007, p. 12). The partnership form of business structure is considered ideal for the passing on of tacit skill as partners and senior members of

³⁵ Professionals excluded administrative and clerical employees.

the firm undertake the role of mentors and supervisors. Junior members are also introduced to existing networks upon which they can expand. According to Morrison and Wilhelm (2007, p. 15), “managing the information networks upon which security issuance relies is a tacit skill”.

Tacit skill is also important to the corporate restructuring and mergers and acquisition parts of the business as these transactions require personal relationships that facilitate the origination of transactions, the gentle management of stakeholders and negotiations with external parties. The reliance on tacit skill has been the foundation of the development of the knowhow inherent in investment banking firms during the past three centuries. Unique knowhow, combined with a good distribution network are amongst the most important factors which can differentiate the quality and competence and therefore the attractiveness of a firm to potential clients. The mentoring and training of junior members of a firm is primarily motivated by a desire of the partners to protect the capital invested in the firm. As a good reputation is an important attribute, a well-trained employee who will protect the reputation will also preserve the financial as well as social capital of a firm. Therefore the more that tacit skill can be passed on within the firm, the greater the potential for an enhanced reputation (Morrison & Wilhelm 2007, 2008; Polanyi 1966). This highly valued reputation, closely guarded by partners, is also important for investment banks which co-participate in one another’s equity or bond issues. In these situations failure of the issue will impact adversely on their clients, which may compromise both the issuer and the eventual buyer of the financial securities as well as their investment bank co-participants. This could affect future business as new customers and transaction arrangers react to each investment bank’s historical performance and behaviour.

4.4.3 Tacit Skill Usurped through Incorporation

During the 1960s, an era of corporate conglomerates emerged, where takeover activity was combined with a growing industrial corporate sector, operating under prosperous economic conditions. This environment created an increased demand for capital from industry and in turn from the investment banking firms which had been arranging the related funding and advisory services. Furthermore, the industry was undergoing a period of significant change where innovations in information technology led to an automation of previously manual processes. The nature of many investment banks’ business had altered from an advisory and underwriting focus to one of trading and brokerage where information technology could provide efficiencies. The increase in importance of brokerage is exemplified by the higher proportion of 70% this segment of Merrill Lynch’s business contributed to total revenue of USD 192 million revenue in 1960, whilst the traditional investment banking segment represented only 5% (Morrison & Wilhelm 2007, p. 50). This change necessitated additional computing capability and placed less importance on tacit skill. The computers necessary for this transformation would require further capital investment whilst under a partnership struc-

ture this additional capital was limited to the personal wealth of its partners. As the need for capital outweighed the need for tacit skill, many investment banks began to incorporate their business structures whereby capital could be increased by tapping the investing public (Morrison & Wilhelm 2007, 2008).

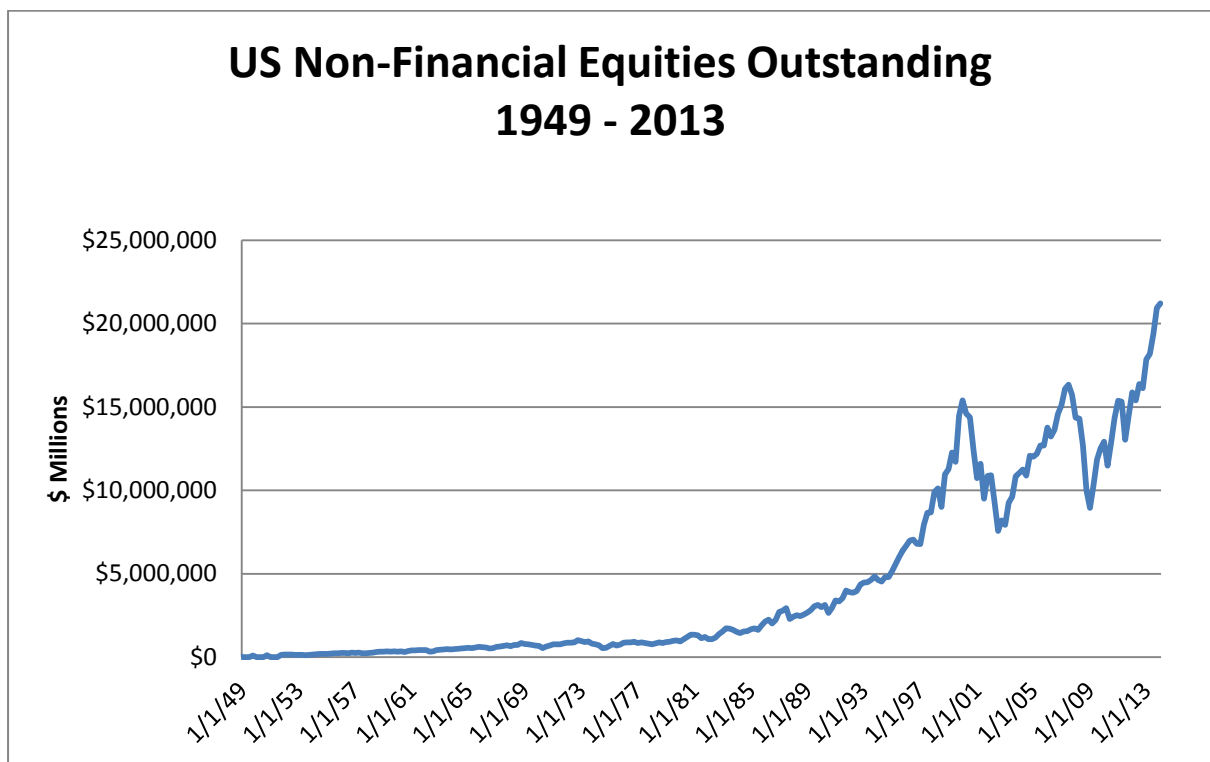
The process of incorporation also required a change to the management structure of the firm. Whereas the governance of a partnership normally rested with an executive committee of peers, the corporate form would entail a board of directors often with some representation of non-executive directors. Control by partners was ceded to boards which were subject to numerous regulations within Corporations Law and a term of office which is subject to a vote at a shareholders' annual general meeting. See section 10.3 for an analysis of LB's Board of Directors and the firm's governance practices. Boards could also approve incentive arrangements for key officers of the corporation. Normal practice would entail the board authorising a bonus pool which would be distributed at the discretion of the CEO or a compensation committee of which the CEO was usually a key member. This was a significant attraction for potential CEOs of the corporation who would have an influence in the incorporation process. As incentives included in executive compensation were aligned with performance generally, the limited liability status of a corporation meant that CEOs could take abnormal risks with the expectation of generating abnormal profits without placing themselves at personal financial risk. Further a CEO was not compelled to allocate a share of the profits with other executives and could therefore monopolise the bulk of the available bonus pool. The incentives however for partners were limited to their drawing rights from their current account in the partnership and given a partner's direct ownership, there was a reduced propensity for risk-taking for fear of weakening the capital structure of the firm.

The transformation to a corporate form also introduced the problem of employee mobility which had the effect of increased staff turnover. The mobility problem followed from a lessening of staff loyalty, driven by the reduced level of close mentoring by superiors and management's greater access to departmental and employee key performance indicators (KPI's). KPI's enabled employees to be divided between those performing at or above expectations and those underperforming. Whilst the better performing employees were subject to poaching by competitor firms, underperformers were filtered out. The departure of key staff created the problem of a corresponding loss of their associated networks and knowhow.

4.4.4 The Capital Problem for Risk Taking

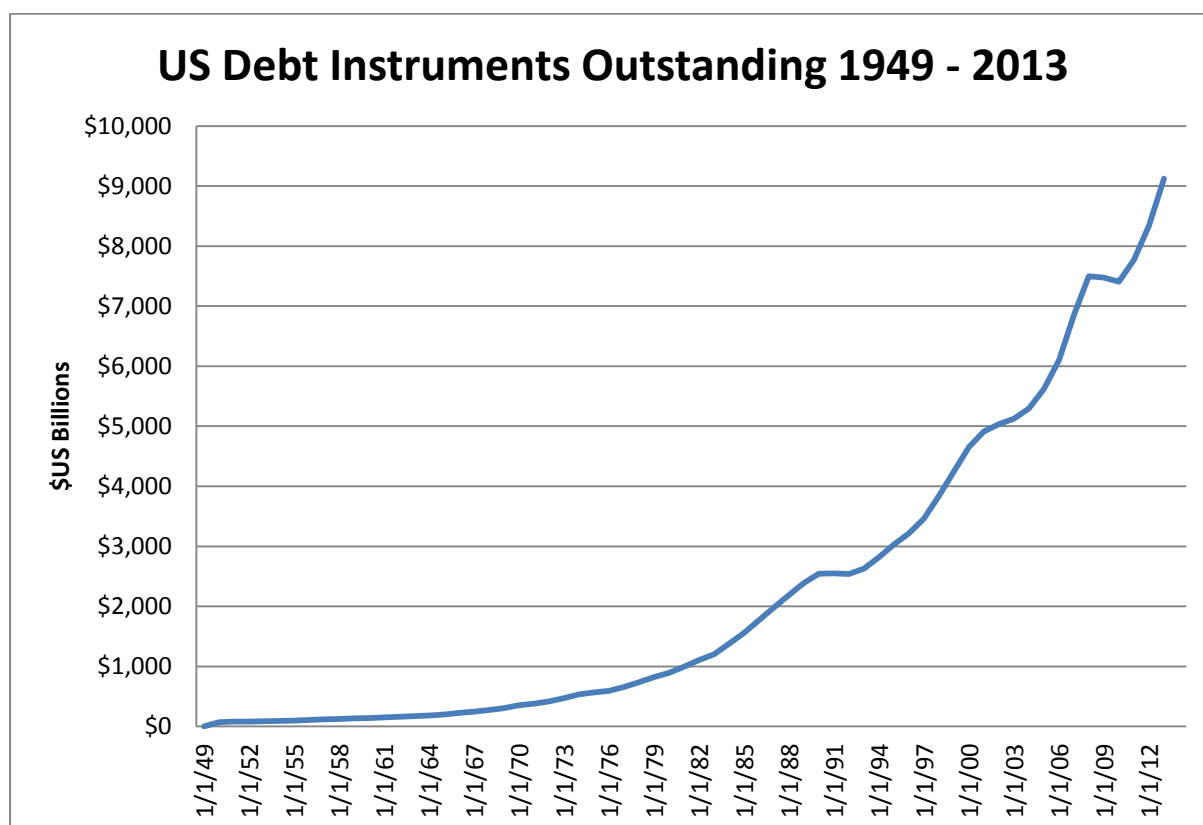
As the US corporate sector grew in the post WW2 era, investment banks were called upon to underwrite an increasing volume and size of securities issues. (Refer to Figure 53 and Figure 54 for charts showing an increasing volume of both equity and debt securities outstanding.)

Figure 53 - US Non-Financial Corporate Equities Outstanding 1949 - 2013



Source: Data for the graph was extracted from Federal Reserve database (Federal Reserve Bank of St Louis 2015d).

Figure 54 - US Debt Instruments Outstanding 1949 - 2013



Source: Data for the graph was extracted from Federal Reserve database (Federal Reserve Bank of St Louis 2015c).

When a securities firm underwrites a new issue of equities or bonds it would need to assume the risk of that undertaking until it is sold to the ultimate investor. The actual cash or credit used by the securities firms to initially subscribe to the bonds or shares during the underwriting period is obtained from either cash at the bank or debt facilities. In their credit assessment of the underwriting firms, the credit providers would require acceptable levels of capital amongst other credit risk attributes. Traditionally, the capital was either supplied by the partners' own funds or once incorporated, by the stockholders of the firm. Two advantages of the corporate form for a securities firm was the access to a potentially larger stockholder base to facilitate additional fund raising through equity and debt issues, and the limited liability of the corporate entity which was unavailable to partners of a partnership form. As new issues became larger during the latter part of the 20th century, it became increasingly difficult for the partners of private partnerships to fund the increasing levels of capital needed to support the bank borrowings required for the underwritings. Partnerships were able to last as long as the speed of economic growth remained slow to moderate. Consequently during the 1970s and 1980s many partnerships succumbed to the ever increasing need for capital and were either unwound, acquired by larger firms or began to incorporate.

The limitations of insufficient capital plagued Wall Street firms and provided an element of discontinuity to the development of the firm because capital in a partnership was quasi transient. As capital was provided by partners of a partnership, it could be withdrawn upon a partner's death or retirement. When this occurred, firms found themselves in difficult financial positions. The recurring theme of capital constraints plagued many firms especially during financial crises which occurred periodically during the latter part of the 19th and early part of the 20th centuries and specifically during the crisis years 1869, 1873, 1884, 1893, 1903, and 1907 (Geisst 2001, p. 60). The burgeoning corporate sector during the period 1960s to 1980s encouraged non-traditional institutions, mainly large commercial banks, to encroach on some of the business segments which were the traditional domain of the investment banking industry. In response to this threat the traditional partnership form gave way to the corporate form as the firms sought to compete by expanding their activities which in turn required higher levels of capital that a corporate form could satisfy.

The business of investment banking prior to the GFC was dominated by traditional firms which were able to adapt to the changing environment in the previous decades. Figure 55 represents the relative size of the major investment banks in 2007, the year acknowledged as the beginning of the crisis and the year before the collapse of LB.

Figure 55 - Ranking of Major US Investment Banks by Market Capitalisation in 2007

Investment Bank	Highest stock price 2007	Highest market value 2007 Billions	Average number of employees 2007
Merrill Lynch	USD 98.68	USD 150.89	64,200
Goldman Sachs	USD 246.40	USD 107.05	30,522
Morgan Stanley	USD 75.15	USD 83.34	56,000
Lehman Brothers	USD 86.18	USD 59.38	28,556
Bear Stearns	USD 170.62	USD 20.47	13,700
TOTAL		USD 421.13	192,978

Source: (Arslan 2009, pp. 5-6).

4.4.5 Incorporation as Mimetic Isomorphism

After the first firms incorporated in 1970, a wave of similar firms gradually incorporated as each firm experienced similar capital constraints and challenging business conditions in the prevailing economic environment. DiMaggio & Powell's (1983) New Institutional Theory suggests that firms tend to replicate business models and practices adopted by other successful industry participants if they are easily understood and provide legitimacy to external stakeholders. This theory further proposes that such isomorphism is undertaken regardless of whether economic benefits accrue. Given the uncertainty in dealing with these challenges in the 1970s and 1980s, firms looked to each other as to which strategic course to follow. Even with the negative consequences of staff mobility and loss of some tacit skill, incorpora-

tion was deemed a viable option to the challenges presented as it offered legitimacy from various perspectives. Parties who accorded this legitimacy included stockholders and creditors, regulators, customers, executive management, existing partners, and lastly the co-participants in transactions.

For partners and stockholders, the corporate form enabled a potential increase in capital to expand business activities. The potential expansion would have signalled a probable increase in earnings receiving stockholder approval so long as the return on capital was not diluted. Naturally the economic benefits would have been uncertain at the time of incorporation however the popular notion that 'bigger is better' could have crept into the perceptions of both partners and following incorporation, stockholders. Creditors including lenders would view a potential increase in capital as an improvement to the balance sheet structure notwithstanding the removal of unlimited liability which is almost always a feature of the partnership structure. A better capitalised business generally translates to a more robust credit profile and therefore a lower probability of default on monies outstanding. A corporate form would subject them to a comprehensive corporate regulatory umbrella. Applicable regulations would oblige disclosure of relevant qualitative and financial information. As an important element of the financial system, any improvement in the level of transparency of investment banks would inform stakeholders and reduce uncertainty in the financial markets. Corporate regulation also imposes discipline on investment banks, covering matters from corporate governance to consumer protection. As potential additional capital would permit investment banks to diversify their service offering and increase underwriting capacity for new securities issues, customers would perceive incorporation with its additional capital raising benefits, as a positive development.

The transformation from the partnership form to the corporate form enabled many investment banks to face the challenges and opportunities of the 1970s and 1980s. The primary challenge was the need for extra capital necessary to meet the financing demands of the growing corporate sector, to shore up balance sheets in the face of increased risk levels, fund the investment required in information technology and compete with the larger commercial banks, which had encroached on some of their traditional business activities. The corporate form also allowed investment banks to introduce generous executive compensation schemes which need not be shared equitably amongst partners. However this evolution meant that the traditional reliance on reputation and tacit skills, had diminished, removing the personal style and image traditionally imbued by the partners.

Ultimately, the rapid growth of the corporate sector attracted some Machiavellian characters seeking to exploit the market conditions. This has been a pattern throughout the history of investment banking. The US corporate sector and the investment banking industry have been littered with a series of scandals where emboldened individuals undertook actions with little or no transparency to maximise personal benefits. The resultant scandals

which emerged prompted a cycle of reactionary responses which typically involved the introduction of further regulation.

4.4.6 Regulation – A Reactionary Response

Most of the large corporate scandals in the US, from Jay Cooke's 1873 collapse to the 2002 corporate scandals³⁶, can trace their causes to the confluence of the same three general factors: risk taking; competition; and manipulation of the corporate form (Skeel 2005a). Given that most CEO compensation structures involved a combination of shares and options, CEOs can expect a large payoff if the company's share price increases, however, if share prices decline, the CEOs personal capital is not at risk. This can introduce a moral hazard problem whereby CEOs are motivated to take higher risks to take advantage of potentially large bonuses (Skeel 2005a). Therefore, theoretically, CEOs are generally incentivised to take risks up to a point where bankruptcy costs³⁷ equal the marginal return of the risking up of the business.

The second factor is competition. Although competitive markets are generally viewed as healthy for an economy, they too can reinforce managers' incentives to take risks. The US has had an historic dislike for concentrated economic power, in favour of industries with a multitude of competing companies. In this kind of marketplace, the success of a business innovator attracts competitors. If an innovative company's profits are eroded by the influx of competitors, its managers may be tempted to respond by taking increasingly misguided and even illegal risks, or disguising their precarious finances, as they attempt to replicate their early success.

³⁶ In 2002 there were a high number of corporate scandals which involved accounting anomalies. Such misdeeds typically involved complex methods for misusing or misdirecting funds, overstating revenues, understating expenses, overstating the value of corporate assets or underreporting the existence of liabilities. US companies involved included: Adelphi, AOL, Bristol-Myers Squibb, Duke Energy, Dynegy, El Paso Corporation, Freddie Mac, Global Crossing, Halliburton, Homestore.com, ImClone Systems, Kmart, Merck & Co., Merrill Lynch, Mirant, Nicor, Peregrine Systems, Qwest Communications, Reliant Energy, Sunbeam, Symbol Technologies, Tyco International, and Worldcom.

³⁷ Bankruptcy costs are all the costs for a corporation associated with an increase in the probability of default on debt. The closer a corporation reaches the point of bankruptcy, theoretically the higher the bankruptcy costs, particularly as management time is distracted by matters related to bankruptcy instead of being focused on the operations of the business. .

The final factor is manipulation of the corporate form. The ability to tap large amounts of capital in enterprises that are set up as corporations, together with the large number of people whose livelihood depends in one way or another on the business, means that an executive who takes excessive or fraudulent risks may jeopardise the financial lives of thousands of employees, investors, and suppliers of the business. The corporate form itself can also multiply the opportunities for mishaps. By permitting corporations to hold the shares of other corporations in the late nineteenth century, lawmakers gave corporate managers the ability to store some of the assets of a business in one corporate entity and other assets elsewhere. This corporate smoke and mirrors figured prominently in the collapse of Samuel Insull³⁸ and other utility empires in the 1930s, and it was equally central to Enron's³⁹ managers' efforts to keep investors in the dark as they ratcheted up the corporation's risks. Ultimately this technique was also used by LB which made extensive use of special purpose vehicles and other unusual accounting interpretations such as those known as 'Repo 105' – refer to 9.1.2 for a fuller explanation of this financial transaction.

Once a corporate scandal is revealed there is often public indignation which incites extensive corporate reforms that simply would not be possible in a more imperturbable corporate and financial environment. For example there were regulatory implications following many scandals, in the 1870s, the 1930s and the early 2000s. An early example is when Jay Cooke's business empire collapsed in September 1873, which followed a series of railroad scandals that also included a conflict over the Erie Railroad⁴⁰ and corruption over the funding of the

³⁸ Samuel Insull (November 11, 1859 – July 16, 1938) was a US businessman who developed electrical infrastructure in the US. His conglomerate failed during the Great Depression following which he was accused of profiting personally by selling worthless stock to unsuspecting investors who trusted him because of his position and reputation.

³⁹ Enron Corporation was an US diversified corporation whose main business was the operation of energy generating assets and the trading of commodities including electricity. When the corporation failed in 2002, it was the largest bankruptcy in US history up to that time. The bankruptcy followed the discovery of fraudulent accounting practices and financial reporting. The enactment of the Sarbanes–Oxley Act of 2002 was largely in response to the events surrounding the Enron collapse.

⁴⁰ The Erie scandal of the 1860s, involved a hostile takeover attempt on the Erie Railroad by a group of investors including Daniel Drew, James Fisk and Jay Gould. These investors fraudulently injected 50,000 shares of the Erie Railroad so as to facilitate the takeover which following legal action and new legislation was successfully executed.

Union Pacific Railroad⁴¹. The US government responded by cancelling the subsidies that had been used to finance the railroads. In Pennsylvania, the state government responded to the scandals by amending the state constitution to prohibit the state from authorizing any government entities "to obtain or appropriate money for ... any corporation, association or individual" (Skeel 2005b, p. 157). Similar statutes in other states were, in a sense, an early effort to limit corporate influence over the political process. According to Skeel (2005b), the 1873 crisis spurred further regulation. The scandal would eventually contribute to railroad rate regulation through the enactment of the Interstate Commerce Act of 1887 and to federal regulation of antitrust issues under the Sherman Act of 1890.

The corporate scandals of the 1930s inspired another major wave of corporate reforms. Under the presidency of Franklin D. Roosevelt congress enacted a broad array of sweeping reforms that still provide the principal framework of US corporate and market regulation. See section 4.3.1 for details of the major pieces of legislation. In the 1940s, Richard Whitney, the head of the New York Stock Exchange (NYSE), was found to have misappropriated several million dollars from the exchange. The reaction to his misconduct enabled SEC Chairman, William Douglas, to coordinate a major restructuring of the exchange. In the early 1970s, following the Watergate scandal, investigators discovered that several major US corporations had allocated funds for bribing foreign officials. In response, the US government enacted the Foreign Corrupt Practices Act, which forbids payments from US corporations to foreign officials. Most recently, scandals involving Enron and WorldCom inspired the Sarbanes-Oxley Act of 2002. See section 4.4.7 for details of this Act.

Each of these reforms followed the same pattern of an alarming scandal which stimulates the public outcry for government and or regulatory action. This action is usually in the form of legislative reforms that provide the federal regulatory framework for the subsequent pe-

⁴¹ The Union Pacific Railroad scandal involved the awarding of favourable contracts by the Union Pacific to a company known as Credit Mobilier which was owned by the majority stockholders of the Union Pacific Railroad. In an attempt to conceal the transaction, shares in Credit Mobilier were transferred to a group of US congressman who ensured the passing of legislation covering government subsidies for the construction of the railroad.

riod. As a new wave of scandals emerged in the late 1990s and early 2000s, the typical reactionary response of introducing new regulations was again triggered.

4.4.7 Regulation – Post WW2

Following WW2 the reconstruction of Europe combined with the re-tooling of US manufacturing and growing consumer demand led to a burgeoning US economy. This combined with an absence of major corporate scandals up until the 1990s, engendered a liberal approach to regulatory reform. It was not until after the late 1990s that a wave of new legislation was introduced – again largely prompted by corporate scandals. These scandals which comprised fraudulent activities resulting in the collapse of corporations such as WorldCom, Enron and Global Crossing, prompted public indignation as is common after corporate scandals are revealed. The prevailing public sentiment led to a series of legislation.

The major pieces of legislation which impacted on the investment banking industry during this post war period include the Gramm-Leach-Bliley Act, the Sarbanes-Oxley Act, Regulation Analyst Certification (Regulation AC) and more recently, but outside the time period of this thesis, the Dodd-Frank Act. Each piece of legislation was seen to be a reaction to a crisis or series of events which had an adverse impact on the investing public. In some cases the ultimate legislation was seen to be a watered down version of the bill originally introduced to Congress, typically as a result of strong lobbying from the investment banking industry (Kroszner & Stratmann 1998). See section 8.2.2 which discusses the power of investment bank lobbying. A brief overview of selected key legislation which impacted the investment banking industry and introduced at the end of the 20th century and soon thereafter, is included in the following sections.

The Gramm Leach Bliley Act of 1999 essentially repealed the Glass Steagall Act of 1933. The new act allowed commercial banks and investment banks to again operate within a single group. The larger combined group, it was argued, could withstand downturns better than if they were split. The complementary business models implied that in a thriving economy when cash levels were high, banks could improve profitability by increased lending funded by higher levels of deposits. Conversely, whilst the corporate sector was well funded by internal cash generation, demand for securities issues would be low, thereby impacting negatively on investment banks. The balance to each other's financial performance was purported to generate less volatile earnings and therefore a more stable financial system. A second argument centred on the unfair playing field that Glass Steagall had created. Whilst US investment banks had to comply with the separation principle, the US based European investment banks and commercial banks were able to continue to operate as combined units. In view of the globalisation of the industry, amalgamations between investment banks and commercial banks was deemed necessary to compete with international participants.

The Sarbanes Oxley Act of 2002 was a direct reaction to the abovementioned corporate scandals of the late 1990s and covered wide ranging reforms focused on improving corporate governance. The act impacted on investment banks insofar as it intended to foster greater transparency. Investment banks were required to separate the activities of share analysts from the underwriting departments thereby lowering the risk of biased research reports. Other governance related sections of the act impacted directly and indirectly on investment banks including provisions for greater auditor independence, requiring corporate executives to formally attest to any information made public, requiring greater disclosure by firms issuing securities, and a general improvement on corporate compliance provisions supervised by the SEC.

The Regulation Analyst Certification Act of 2003 intended to improve the quality of research reports produced by investment banks by requiring analysts to certify that the research reports represented an accurate opinion of the analysts' view. Further it was intended to improve transparency by requiring analysts to disclose any remuneration directly related to the research reports.

4.4.8 Capital Regulation

In the investment banking industry the principal section of prudential regulation aimed at protecting stakeholders was a rule governing minimum capital levels - Rule 15c3-1 under the Securities and Exchange Act of 1934. This rule was amended by the US SEC in 1975 and revised in 1997 and 2004 (Securities and Exchange Commission 1975, 1997, 2004). A key amendment to this rule in 2004, commonly known as the 'Net Capital Rule', effectively permitted the larger investment bank groups to raise their allowable leverage from a level of 12 to 1 to over 30 to 1 (Coffee 2008). The leverage ratio required a registered broker-dealer owned by an investment bank to maintain 'aggregate indebtedness' to a maximum of 12 times (or 15 times if the investment bank provided an early warning to the SEC of a potential breach). This ratio can also be expressed as holding a minimum amount of net capital equal to at least 6.67 percent of total 'aggregate indebtedness'. However Sirri (2008) notes that broker-dealers subject to the 12-to-1 net capital leverage ratio effectively understated their ratios as the regulatory definition of 'aggregate indebtedness' excluded securities financing transactions such as repurchase agreements which constituted substantial portions

of an investment bank's balance sheet. Moreover, the Net Capital Rule never applied at the investment bank holding company level, where the group would conduct risky transactions such as originating and warehousing of real estate and corporate loans and derivatives transactions involving CDOs and Residential Mortgage Backed Securities (RMBS)⁴² outside the balance sheet structure of the broker-dealer subsidiary (Sirri 2008).

According to Sirri (2008) no regulator in the US as at 2008 was given explicit authority and responsibility for the supervision of investment bank holding companies with bank affiliates. Although the US regulatory framework included mandatory capital requirements by the Federal Reserve Board for commercial bank holding companies, holding companies of investment banks that did not have Federal government regulated US banks within the consolidated group, were subject to a voluntary regime of regulations. Therefore, there was a gap in the US regulatory framework for large US investment bank holding companies to meet net capital adequacy limits and maintain liquidity on a consolidated basis (Sirri 2008).

A history of the capital regulations for investment banks is useful in understanding their effect on the industry. The concept of a rule requiring a broker-dealer to maintain a liquidity buffer to protect customers' claims on the firm originated from the aftermath of the Great Depression of the 1930s when the SEC established Rule 15c3-1 under the Securities and Exchange Act of 1934. This Act required registered broker-dealers to maintain minimum levels of liquid net assets in order to speedily liquidate positions to meet client claims (Wolfson & Guttman 1972). In the late 1960s, US broker-dealers were inundated with unprecedented securities trades which caused processing failures. The broker-dealers relied on short-term debt to fund their portfolios of securities and as investors attempted to liquidate their holdings, these funding lines were placed under severe stress causing defaults amongst industry participants. The failures precipitated a financial crisis resulting in substantial losses for investors and a loss of confidence in the stock market. Following this crisis, the SEC introduced a capital regulation in 1975 requiring broker-dealers to maintain minimum levels of capital and liquidity (Wells 2000). These regulations however did not extend to the holding companies of the broker-dealers. The 1975 net capital rule involved a process of two calcu-

⁴² A RMBS is a security issued through a securitization process by a special purpose vehicle established to hold a pool of residential mortgages which are either originated by a related sponsoring financial institutions or purchased from another financial institution.

lations. Firstly net capital was calculated from the broker-dealer's balance sheet as total capital less deductions such as illiquid assets, unsecured receivables, charges for aged credit exposures and market risk haircuts⁴³. Secondly the required net capital was calculated as a percentage of 'aggregate indebtedness'. Actual net capital was required to exceed the required net capital (Haberman 1987, p. 4).

The 1980s represented a period of growth for the securities industry and as broker-dealers expanded operations, regulators focused attention on the solvency of the broker-dealers' holding companies as well as the broker-dealer subsidiaries however resisted introducing specific regulations covering holding companies. Concerns were realised with the bankruptcy in February 1990 of Drexel Burnham Lambert group which operated as an investment bank with a broker-dealer division (Carney 2012). Drexel Burnham Lambert's bankruptcy prompted the SEC to conduct assessments of groups which were affiliated to broker-dealers. Formally these measures included: the establishment of the Market Reform Act 1990 requiring larger broker-dealers to report risk-related data of group entities to the SEC; persuading industry participants to form a Derivatives Policy Group to voluntarily supply information about their derivatives activities which were still unregulated; and, a program involving the supervision of OTC derivatives transacted by broker-dealers.

The 2004 amendments to the Net Capital Rules addressed the need to recognise the requirement for calculating net capital for the wider investment banking group as well as the broker-dealer subsidiaries. When Congress enacted the Gramm-Leach-Bliley Act in 1999, it neglected to authorise any government agency to regulate large investment bank holding companies such as Goldman Sachs, Morgan Stanley, Merrill Lynch and Bear Stearns. The 2004 amendment effectively established a class of larger investment banks to be known as Consolidated Supervised Entities (CSEs). The CSEs could volunteer to comply with the Net Capital Rule under SEC supervision. Otherwise they could remain under the existing regulations which applied solely to their broker-dealer subsidiaries. The five main elements of the CSE program entailed the following:

⁴³ The haircuts refer to the discounts applied to the market value of securities to reflect their risk characteristics. The value of the securities after the haircut is used in the calculation to determine the available liquid assets a firm holds to meet liabilities which are unsubordinated, whilst retaining a margin of safety.

First, CSE holding companies are required to maintain and document a system of internal controls that must be approved by the Commission at the time of initial application. Second, before approval and on an ongoing basis, the Commission's staff examines the implementation of these controls. Third, CSEs are monitored for financial and operational weakness that might place regulated entities within the group or the broader financial system at risk. Fourth, CSEs are required to compute a capital adequacy measure at the holding company that is consistent with the Basel Standard. Finally, CSEs are required to maintain significant pools of liquid assets at the holding company, for use in any regulated or unregulated entity within the group without regulatory restriction. This liquidity pool is sized to ensure that the holding company has sufficient stand-alone liquidity to meet its expected cash outflows without access to unsecured financing for a period of at least one year Sirri (2008).

Investment banks could qualify as CSEs if they had net capital of more than USD 5 billion and therefore take advantage of two key concessions relating to the calculation of net capital. Firstly CSEs were allowed to calculate net capital using their own risk models. Secondly they could adopt the same risk weightings which were adopted by commercial banks under their Basel II capital adequacy guidelines. These risk weightings were derived by the Bank of International Settlements as part of their prudential guidelines and used to weight assets in accordance with their risk to arrive at a total risk weighted asset base against which capital was applied in the capital adequacy calculations. As at 2008, four major investment banks, including LB, Goldman Sachs, Merrill Lynch and Morgan Stanley volunteered to be classified as CSEs and comply with the regulations (*Review of Regulatory Proposals on Basel Capital and Commercial Real Estate* 2006, p. 114). The SEC also deferred its supervisory function over a CSE affiliate, to the relevant functional regulator of that CSE affiliate.

Not only did the 2004 amendments increase the allowable leverage for CSEs, they contributed to a change in business direction of the investment banks. According to Friedman and Kraus (2011), the 2004 amendments incorporated risk weightings for assets that were used in the net capital calculations for investment banks which were similar to those used in the capital adequacy calculations included in the Basel II regulations for banks. These risk weightings favoured the holding of mortgage assets which were risk weighted at 50 percent of the principal amount and investments in mortgage securities which were risk weighted according to the credit rating applied by the independent CRAs. For example mortgage bonds with a credit rating of 'BB' or 'BBB' were weighted at 100 percent whilst mortgage bonds rated 'A' were risk weighted at 50 percent and bonds rated at AA or AAA were risk weighted at 20 percent. Therefore, the higher a bond was rated, the lower the required capital allocation. When capital was considered a scarce resource, banks and investment banks preferred assets with relatively lower risk weightings and therefore the issuance of mortgage-backed securities expanded significantly following the 2004 amendments (Friedman & Kraus 2011). Accordingly, the balance sheets of investment banks accumulated higher proportions of mortgage-related assets.

The 2004 amendment is viewed as a seminal point in the history of capital regulation for US investment banks as it allowed the large investment banks the choice to volunteer to be classified as a CSE and in turn the choice to utilise an internal model to calculate their own capital adequacy ratios. All major investment banks elected to use the internal model approach which provided them with significant flexibility in their calculations of the components of the capital ratios such as asset classifications, probability of defaults for different credit risks, and loss-given default rates. The decision to be classified as a CSE was also a legitimacy-seeking behaviour by agreeing to be subject to the newest regulatory initiative. A testament to the inadequacy of this lax regulation is exemplified by the SEC's prompt reaction to the LB bankruptcy. In just eleven days following the bankruptcy, the SEC introduced legislation requiring large investment banks to submit to compulsory regulation (Cox 2008a).

The pre-2008 accommodative legislative environment which included a generous capital adequacy requirement was sufficient to encourage the investment banks to maximise their leverage, and take advantage of new and innovative business activities, which introduced new and heightened risks for the firms. These risks were found to be understated and misunderstood leading to dire consequences.

4.5 Summary and Discussion

This chapter provides a chronological outline of the history of the US investment banking industry since the 18th century, highlighting and analysing a sample of critical events and some key individuals who had a material impact on the development of the industry. The chapter briefly charted the backgrounds of some of the personalities who pioneered and imparted their influence within their own firms, to the industry, to government and institutional authorities and to the wider financial and corporate communities.

The chapter provided the historical context of this thesis and illuminated some of the common themes which pervaded this evolution. These themes involved the personal relationships developed with government authorities and officials, and the influence exerted by investment bankers through their networks and the personal characteristics and behaviour, including organisational culture found in US investment banks since the American Revolution. The benefit of highlighting these themes is to draw a comparison between them to those factors which impacted on the failure of LB, in particular the characteristics exhibited by the senior management and organisational culture of LB.

The theoretical framework used to analyse the influences encompassed Clegg's (1989) Theory of Power and DiMaggio & Powell's (1983) New Institutional Theory. The use of the two theories together explained the influential roles played by key individuals such as Haym Sa-

lomon, Robert Morris, Albert Gallatin, David Parish, John Jacob Astor, Stephen Girard, Nicholas Biddle, Clarke Dodge, James Gore King, Anthony Joseph Drexel, and the well-known John Pierpont Morgan. These individuals are highlighted since they represent a sample of prominent US investment bankers operating during the formative years of the industry. They were therefore the early leaders who were able to shape the culture and practices within the industry from its beginnings. This thesis argues that this culture and the many practices formed in the early years of the industry persisted through to the pre-GFC period.

4.5.1 Formal and Real Power

The power acquired by these individuals was typically fashioned through the combination of unique skills and knowhow, superior ability to distribute financial instruments and special relations developed with key individuals within commercial and government circles. These attributes and practices, and the accompanying power would set the bankers apart in their industry and commerce generally and offer them a privileged position in conducting further profitable business. An interesting distinction in the power relationships between the selected investment bankers is that perceived as ‘formal’ power resting with government and official institutions, and the ‘real’ power which was exercised by investment bankers.

The power held by government is typically created in Clegg’s (1989) dispositional circuit where it is responsible for the establishment of regulation and laws. The ability to establish the rules and discipline associated with the laws and regulation is the source of this formal power. The power that is primarily generated in the dispositional circuit relates to the similar fixing and refixing of rules to which an organisation is subjected. A breach of these laws and rules in the ordinary course of daily events would result in punishment either through jail sentences, official sanctions or penalties, which are the means by which formal power can be enforced. As explained in this chapter there were numerous instances where individuals escaped this punishment. Moreover, through special relationships, they prospered economically by pursuing their objectives regardless of the formal legal and regulatory frameworks. The evasion of punishment and ability to direct economic and legal outcomes by the investment bankers reflect a real power which overcame the formal power held by government and other authorities.

Although the formal power held by officials passed through the dispositional circuit whereby rule-makers can fix and refix rules and their meanings, the real power that rested with the investment bankers was created in a more subtle and even obscure way. As a covert instrument, the investment bank’s power proved more potent as it was less obvious to recognise, and therefore mitigate or challenge. Often this power arose out of a need precipitated by crisis, war or technological knowhow. The exogenous environment, in which these sources existed, represented the fertile ground which instigated the process of empowerment. According to Clegg (1989), the facilitative nature of these sources found in the facili-

tative circuit, transmitted the investment banker's power to the episodic circuit where the actions of the investment bankers provided for positive outcomes from which they benefited.

In some instances, the investment banker virtually assumed the unofficial role of the government treasury officials. For example, Haym Salomon advised Robert Morris in raising the required financing for the Continental Congress' war effort during the American Revolutionary War. Further Albert Gallatin, the Secretary of the Treasury sought the direct assistance of the syndicate of well-known investment bankers, Girard, Astor and Parish in structuring and delivering the much needed bond issue to finance the War of 1812, without which the government would have been unable to prosecute the war. Finally, JP Morgan was able to persuade the US government to accept a gold financing transaction to alleviate financial pressure following the panic of 1893. In the process he generated even higher profits by utilising an innovative technique.

4.5.2 Investment Banking Organisational Culture

Organisational culture can be defined in a variety of ways. It is commonly described as a set of shared assumptions that guide what happens in organisations by defining appropriate behaviour for various situations (Ravasi & Schultz 2006). Organisational culture guides the way employees either as individuals or in discreet groups interact with each other, and with stakeholders. It may also influence how much employees identify with their organisation (Schrodt 2002). As identified in this chapter a recurring theme is the persistence of an organisational culture within the investment banking industry which often allowed for a Machiavellian approach to business. This was typified by a relative absence of morals, where ethics and professional standards were sacrificed in favour of the profit motive. New Institutional Theory is helpful in understanding how a common culture pervaded the industry and was perpetuated through generations. Once the success of an investment bank's activities was observed by other industry participants, an isomorphic process ensued such as the replication of effective distribution networks, the use of advertising for bond issues, creating useful relationships with government, development of innovative securities transaction structures and networking with influential individuals, corporations and other firms. In most cases these influences were either mimetic or normative in nature. The security and legitimacy generated by the isomorphic process encouraged a cultural consistency within the industry. The public cultural and moral standards of the early years of the investment banking industry sanctioned actions of key individuals. The consequent behaviour continued into the 21st century as will be discussed in the latter chapters of this thesis

The chapter also highlights certain events in the history of investment banking which can be interpreted as milestones as they presented opportunities and posed threats to participants and in certain cases generated reactionary responses from government which would impact

the development of the industry in general. These events also set the context within which the key individuals operated. The following section outlines the history of LB, which exhibits some parallels to the development of the industry and permits a more detailed and specific exploration of the institutional and behavioural characteristics within the firm.

CHAPTER 5 **HISTORY OF LEHMAN BROTHERS**

This chapter draws upon the themes established in the previous chapter relating to the historical influences on the investment banking industry and draws parallels with the influences impacting LB. The purpose of this chapter is to outline a chronological history of LB highlighting events and personalities that have contributed to the development of the three themes of this study: reliance on key relationships with government authorities and officials; influence through official, personal and commercial networks; and the impact of personal characteristics and organisational culture. Factors relating to these themes led to the 'survival at all costs' mantra embedded within LB in the days prior to its downfall.

This chapter is structured in two sections that relate to the corporation's president Richard Fuld. The first is an account of the pre-Fuld era to develop an understanding of the origins of the firm, taking into account the founders' influence⁴⁴ which was significant to LB's culture. The second section covers the post-Fuld era, which starts with Richard Fuld's presidency of the company and unearths Fuld's influence on the organisation's culture through his own behaviours and set of values.

5.1 The Pre-Fuld Era (1850 – 1994)

A recurring theme in the early history of the firm is a pioneering entrepreneurial culture driven by knowledge of products and markets and implemented through strategies often involving key relationships. The firm's innovative culture prompted the exploration of various markets at their very early stages of development. This pioneering spirit was coupled with the firm's constant search for business opportunities that were similar or adjacent to

⁴⁴ Founder's influence is the process by which a firm's founder(s) exhibits behavioural patterns which establishes a cultural environment within an organisation which governs social interactions within and outside the firm. The founder(s) are distinguished from other members of a firm usually by a position of leadership characterised by an ability to influence others.




their existing operations. In entering these new businesses, the firm was willing to assume different and often higher levels of risk (Geisst 2001).

5.1.1 The Founders

LB was founded in 1850 in the US by three brothers, Henry, Emanuel and Meyer Lehman, Jewish emigrants from Bavaria (currently part of Germany). The Lehman brothers were sons of Abraham and Eva, the father being a cattle and wine merchant in a small village in Bavaria. Henry started working for his father from the age of fourteen. Henry's grandfather Seligmann Low was also a trader travelling around Germany selling skins, grains, wool and spices. The local law allowed only the eldest son of a Jewish family to remain in the village into adulthood, and as Henry was the sixth of 10 children and the second eldest son, he intended to leave the village as a young man. Henry, the eldest of the three brothers, was the first to immigrate to the US in 1844. He was born under the name of Hayum Lehmann, as confirmed on the passenger list of the Burgundy, the ship which carried him to New York from Bavaria and shortly after arrival changed his name to Henry Lehman (Chapman 2010). Henry sailed to Alabama USA in search of a new life, following two friends Meyer and Arnold Goldschmidt who were travelling to see a relative in Mobile, Alabama (Flade 1999).

Being a member of a minority group, Henry first learned to assimilate into the local society by changing his name and attending a Jewish school in the morning and a Catholic school in the afternoon. This adaptability combined with his family's merchant and trading background laid a solid foundation for his future commercial exploits (Geisst 2001).

Figure 56 – Pictures of the Lehman Brothers

Henry Lehman	Emanuel Lehman	Meyer Lehman
		
Source: (Herbert Lehman Collection n.d.)		

Common to other German Jewish families, they immigrated to the US to pursue a better life and as often occurred they established commercial interests. These families fell within the

'Our Crowd' group and amongst others included: the Seligmans; Kuhns; Loeb's; Goldmans; Sachs'; Schiffs; and Lewisohns (Birmingham 1967; Geisst 2001). In their home countries many of these families were involved in the cattle trade and once in the US, they quickly established reputations as being successful in business, initially as merchants and traders. "Buying and selling was, for them, like mother's milk" (Libo 2008).

Initial Signs of Normative Influence

In an attempt to assimilate into US society, Henry anglicised his Christian name from Hayum to Henry whilst his surname took upon a less German look by dropping the last 'n'. Even the pronunciation of the surname changed from 'Lay-man' to a more anglicised 'Lee-man' (Chapman 2010). The simple act of changing his name signified a desire to conform to the American way of life which would facilitate his immersion into society. Further, the desire to assimilate into the US would help him avoid potential anti-Semitism and promote acceptance into the commercial networks which would assist in the development of the business empire.

The act of conforming to social norms to facilitate integration into society can be interpreted as an example of DiMaggio & Powell's (1983) normative isomorphism where legitimisation by the business community was considered beneficial for business. Henry exhibited an emotional intelligence and adaptability to endear himself to various sectors of society. He was able to mix with anglicised society whilst retaining his intimacy with the Jewish community (Chapman 2010). The pressure to conform to the values and expectations of both groups was important for his commercial success. Henry soon established a business operating as a dry goods and grocery store which at this stage was known as 'H Lehman' (Wechsberg 1966, p. 233). He settled in Montgomery, Alabama as the cotton industry in the state was experiencing significant growth. Henry predicted that the local economy would benefit from such growth and anticipated that the associated benefits would support a business involved in consumer supplies (Wechsberg 1966). Henry's younger brother Emanuel Lehman, arrived in the US in 1847 to join the firm, which then changed its name to 'H. Lehman and Bro.'. Emanuel commenced working in Mobile, Alabama as a trader on behalf of the firm. He purchased supplies using credit from a Jewish wholesale supplier known to his family in Bavaria and sold the merchandise further down the Alabama River to farmers and local residents (Libo 2008). Thus with the assistance of a family contact, relying on Jewish connections and an instinct for trade, the firm established its roots.

Power through Connections

The advantage gained from the trade credit enabled Emanuel to buy supplies without the need for his own cash resources or with any other financing arrangement which would incur interest. This would provide the firm with a competitive advantage against other merchants,

many of whom had to pay for credit. In the episodic circuit where the application of resources is a precursor to the exercise of power, Emanuel was able to achieve a position of superiority through his financing strategy. The family connection within the Jewish community constitutes a relationship where the sense of obligation between family members led to a socially constructed meaning which guided their commercial interactions. The guidance is akin to an unwritten rule prompting assistance between like-minded members of the Jewish community. Clegg (1989) places this unwritten rule in the dispositional circuit where rules are fixed. The rule which fosters trade and financial transactions amongst the Jewish community provides commercial benefit to the participants. The obligatory passage point represented by the the connections within the Jewish community enabled the transfer of power to Emanuel in the episodic circuit where the day to day financing transaction occurred. The manifestation of this power was the competitive advantage achieved in his business dealings.

The dispositional circuit is concerned with the members of a group that formed through social integration. The relevant larger group comprises the business community in which the Jewish community was a sub-group. The members of this sub-group mostly treated each other as equals, however, as a sub-group they largely considered outsiders as legitimate competitors. The relevant rules which they followed reflected a common unwritten understanding of co-operation between members. This us-them culture provided stability within the sub-group and legitimised practices accepted by the wider Jewish community.

5.1.2 Expansion of the Business

Henry and Emanuel were soon followed by a third younger brother Mayer Lehman who emigrated to the US in 1850 to join the business, and thus the firm was named Lehman Brothers, the name it carried until 2008. The merchant business sold a variety of manufactured cotton products, and raw cotton which were often accepted as payment for other products sold by the store (Libo 2008).

Figure 57 - LB Montgomery, Alabama Store



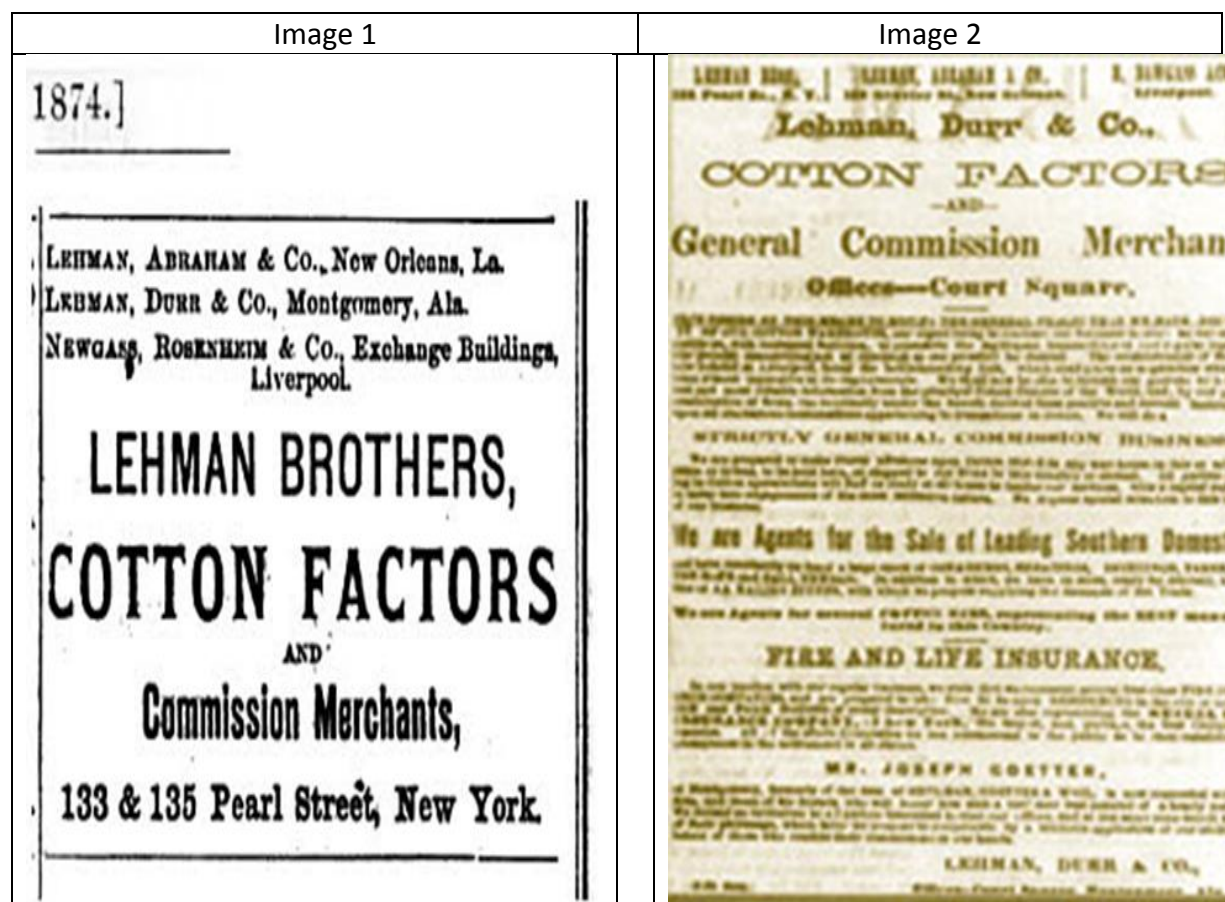
Source: (US Slave c.1850).

The store was in a prominent location in the commercial centre of Montgomery. The brothers' innate trait for business was again revealed with the realisation that distribution was an important element in trade during that period. This drove them to select a site with excellent exposure to customers. This modus operandi would later prove useful when designing a distribution strategy for the securities trading activities in the early days of the firm. In commenting on the firm's beginnings and bartering activities, Mayer's son Herbert, described it as follows:

the farmers would come in with their cotton and trade it for shirts and shoes and fertilizer, such little as was used in those days, and seed, and all the necessities. That's how they got started in the cotton business (Cohen, p. 116).

During the 1850s, cotton became one of the most important commodities in the US and its increasing value spurred the growth of the cotton trading segment of the LB business (Wechsberg 1966, p. 233). The cotton trading business quickly outgrew the original merchandising business and the trading culture which permeated the firm's organisational behaviour throughout its 150 year history was born.

Figure 58 - Newspaper Advertisements Promoting LB's Trading Business

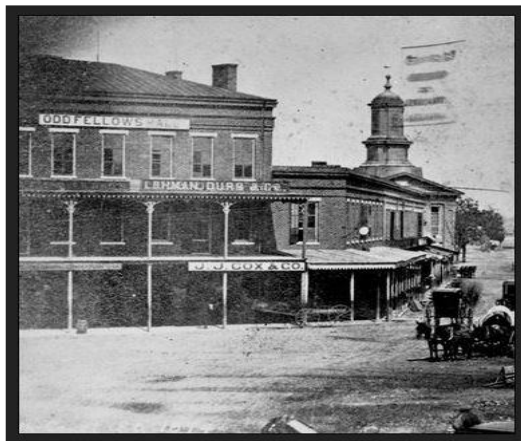


Source: (Finfacts 2009; Richardson 2010).

The brothers split their responsibilities to cover a wider range of business interests and streamline the operations of the firm. In the early 1850s, whilst Emanuel sourced supplies of cotton from New York, Mayer supervised the Montgomery store which continued to trade with the local community. Henry was also involved in real estate investment and as their wealth increased he augmented the practice of extending trade credit to offering long term loans to farmers. The accommodating and innovative Henry accepted both cotton bales and currency as repayment for the loans. This practice was an acknowledgement of the shortage of cash held by the farmers in pre-harvest periods. Following Henry's death in 1858, the remaining brothers established a branch in New York, representing the centre of the cotton broking industry. In close proximity to the branch were the offices of other Jewish families' businesses such as Kuhn, Loeb, Goldman, Saches and Seligmans, all of whom eventually established their own investment banks (Libo 2008).

Figure 59 - Lehman Brothers Branch at 119 Liberty Street, New York

Lehman, Durr & Co



Source: (US Slave c.1850).

5.1.3 New York Network Expands Influence

Mayer joined Emanuel in New York two years after Emanuel's arrival. They moved their premises to Pearl Street where they remained for 10 years, after which they moved again to larger premises at 40 Exchange Place. Emanuel Lehman made New York City his permanent residence. He quickly developed a network and became a director with several prominent financial institutions and organisations such as: Mercantile National Bank, Queens County Bank, Metropolitan Ferry, The 10th and 23rd Streets Railroad, the Third Avenue Railroad, the Alabama Mineral Land Company and the Berry Brice Cotton Company (Ingham 1983, p. 783).

This group of directorships exposed Emanuel to numerous other directors and executives who wielded influence in New York City. A valuable network of influential contacts was be-

ing developed which would become useful in the day to day business dealings of the firm. The early formation of this business network put LB in direct contact with potential customers, referrers of business and transaction partners. The customer and referrer groups would come from the various boards on which Emanuel sat. The transaction partners, who regularly shared in underwriting transactions as co-participants in securities issues, primarily consisted of other Jewish family firms who shared similar beginnings and were conveniently located within close proximity of LB's office (Geisst 2001). There were two forces at play in generating the influence these valuable networks were able to impose, which are discussed below.

Normative Influence of the Jewish Connection (Our Crowd)

Firstly, the connections with other Jewish firms provided for reciprocal business opportunities between the members of this group known as 'Our Crowd'. This form of co-operation is viewed as a normative influence. As many securities issues were too large for one firm to underwrite, a common practice was to syndicate the underwriting exposure amongst two or more firms. The efficiency and risk benefits resulting from this practice became normalised within the industry. By allocating a tranche of an underwriting commitment to a fellow Jewish firm, LB was able to achieve two advantages.

One advantage accrued from establishing an obligation for a continuing reciprocity of business; a second benefit involved efficiency in processing a transaction. The efficiency arose through a common tolerance, understanding and appreciation of the risks of each transaction allowing any analysis of the issuer to be expedited. If LB chose a co-participant firm with a different view of the risk, that firm was likely to decline the transaction leaving LB the arduous task of finding another firm willing to co-participate. These practices were institutionalised so much so that they persist today, whereby lead arranging banks seek out banks with common credit standards to co-participate in transactions. This conformity of practice throughout the history of the professional field represents an example of DiMaggio & Powell's (1983) normative influence. This normative influence impacted their business practices especially in their sharing of risk in underwriting transactions, which was determined collectively and affected their cognitive approach to their day to day dealings and routines. For example Supple (1998), referring to the friendship and business association between the Goldman and the Lehman families in relation to transactions, states that:

the Goldman family had to rely more heavily on the intangible factor of friendship. For associates were needed to help supply capital and it was clear that in view of its inexperience, no established house would fully participate without the strongest of safeguards. In these circumstances it was only natural to turn to Lehman Brothers... [who] were not only a member of the German-Jewish elite, but close personal friend of the Goldmans (Supple 1998, p. 173).

Cohen (2012) proffers three reasons to explain the rising prominence of the Jewish family-based investment banks in the period immediately following the Civil War. Firstly, many firms were already successful in the years prior to the war due to their common activity of starting out as merchants which enabled them to accumulate capital to take advantage and establish other finance-related businesses in the post war period. Secondly, Cohen cites that the “familial and ethnic networks were important in Southern Jewish economic life. Close-knit networks in the pre-Civil War period provided access to Northern capital and markets, and these networks were extended in the post-Civil War years, as well-established Jewish firms capitalized smaller Jewish businesses” (Cohen 2012, p. 130). Additionally German-Jewish families imported from their home country the concept of solidarity amongst their own ethnic community. In tandem with the close business associations, the families shared “common interests and aspirations - an identification of the family and the firm which in the early days...led to a continuous pooling of capital for both private and business use” (Supple 1998, p. 168). Thirdly, Cohen (2012) relates the success of several Jewish firms, including LB to their involvement in the prosperous cotton industry:

Cotton propelled the proprietors of strong antebellum businesses toward upper class status, and it allowed many new postbellum merchants to quickly reach the middle class...Thus, tracing the flow of capital that allowed these Jewish businesses to thrive suggests that cotton, capital, and ethnic networks were critical factors in their growth (Cohen 2012, p. 131).

Dispositional Power from Board Directorships

Membership of various boards of directors enabled Emanuel to attain power directly and indirectly. He did this directly within the firm of which he was a director, in the official capacity of a board member who can apply influence in strategic decision-making, and indirectly through his relationships with other board members. Given the extent of his directorships, this power permeated through the corporate circles of New York and is characteristic of power sourced from an elevated position within a community – one of the preconditions of a power sourced through the dispositional circuit.

In this circuit the clique of directors during the period represented a small but powerful group of individuals who largely controlled commerce in New York, the financial centre of the US. The unofficial membership of such a ‘club’ bestowed a privileged status within the business world and society in general. The informality of these social relations permitted a transfer of favours and influence respectively between members. This process of exchanging favours is considered the passage point through which power was transmitted to the episodic circuit. The favours and influence assisted Emanuel to generate successful outcomes in his day to day business affairs such as introductions to securities underwriting opportunities or appointments to other board directorships.

5.1.4 Profiting from the American Civil War

An important impetus for change was the American Civil War. With much of the firm's operations tied to the economies of the southern states of the US, LB was severely affected by the Civil War (Birmingham 1967, p. 47). The Lehman family was close to the Southern cause during the Civil War with Emanuel fighting in the Confederate Army and later helping to sell Confederate bonds in London (Birmingham 1967).

According to Ellis and Vertin (2003, p. 237), even though "Emanuel was the conservative inside man", he was not afraid to run the blockade⁴⁵ by travelling to Germany to sell cotton acquired in the southern states of America for significant profits. Patriotism was not incongruent with the conducting of business and "may even have involved smuggling..." (Ellis & Vertin 2003, p. 237). This behaviour goes beyond one of an entrepreneurial spirit, to include elements of risk which are deemed extreme. Not only was Emanuel engaged in commercial risk in his attempts to sell cotton in Germany, but he was also incurring personal and potentially legal risks in running the blockade and entertaining any semblance of smuggling.

It was also in the the Lehman brothers' interest to be seen to fit in with the local business community and thereby adopt customs commonly found in the Southern states. During the antebellum period and over the period covering the American Civil War, slavery was common in the Southern states until it was abolished in 1885. As part of their cotton trading activities, the Lehman brothers would have had to regularly deal with cotton growers who routinely acquired slaves as labour for their farms. According to Fleischman and Tyson (2004), the practice of accounting by merchants and farmers at that time was complicit in sustaining slavery and its institutions. "In essence, accounting was used to convert qualitative human attributes into a limited number of discrete categories (age, sex, color) that could be differentiated and monetized in order to facilitate commercial slave trading" (Fleischman & Tyson 2004, p. 393). Given the commercial imperative of having to deal with cotton growers for their business, it was convenient for the Lehman brothers to disregard the moral aspects of plantation slavery. It could be suggested that as members of a minority Jewish community, they were well aware of the power disadvantages of being identified as

⁴⁵ The Union blockade was carried out by the Union navy during the American Civil War to prevent Confederate ships from transporting trading goods. By hindering Confederacy trade the Union was attempting to stifle the Confederate states' economy and disrupt supply of the Confederate armed forces.

a minority. Their attempts at anglicising their name and possibly even Emmanuel's decision to fight in the Confederate Army could be viewed as astute attempts to avoid racial vilification and become subject to the resultant power disadvantage as experienced by the slaves at that time.

In 1862, during the Civil War, when general commerce was limited, LB was searching for alternative business activities and a means of capitalising on its knowledge of the cotton trading business. The firm established a partnership with John Durr, a cotton trader. Durr provided the additional capital required for the construction of a larger warehouse, enabling the firm to engage in higher volumes of cotton transactions (Ellis & Vertin 2003). This business strategy dating back to the 1860s of warehousing commodities to enable larger transactions and therefore increased profitability, is a similar strategy undertaken by other investment banks during the modern era of warehousing subprime mortgages (see section 7.3 for a discussion of modern day financial warehousing).

Both strategies intended to take advantage of the leverage and economies of scale effects on profitability. In the former case however, debt leverage was replaced by John Durr's capital. The use of capital as opposed to debt reduced the overall risk of the venture to the firm. This contrasts to the increased debt leverage used in the case of the subprime mortgage warehouses which were used by LB prior to the GFC.

The founders' influence on the firm was to be significant. Early risks such as establishing a dry goods and grocery store, selling cotton in Germany by running a blockade and the strategy to invest in cotton warehousing were consistent with the brothers' vision for the firm. The strategy to engage in trading businesses where they could add value in terms of knowledge and/or relationships proved to be successful. Obviously founders are crucial early in the existence of any firm, but does their influence persist?

In section 5.1.1, the risk culture established by the founders is shown to persist and manifest itself in activities such as the development of new lines of business; the extension of the client base to include those in riskier emerging industries; the use of complex and innovative financial instruments such as credit derivatives and multi-level securitisation structures; an aggressive acquisition strategy of businesses; and the use of leverage to achieve the associated growth strategies. Further, the practice of exploiting networks also survived within the firm, where networks became useful in the acquisition of new clients – Philip Lehman and Pete Petersen represent good examples of leaders who used their networks to the benefit of the business; and in the influence over regulators and accounting standard setters (refer CHAPTER 8).

5.1.5 Transformation to the Business of Investment Banking – An Exercise of Power

In 1867, after several years of operating as a merchant and trading business, LB undertook its first major investment banking transaction to sell bonds of the State of Alabama. This was not seen as a simple task given the State's poor financial condition following the war. The firm was also appointed as the State's principal financial advisor for its debt obligations, thus beginning a long tradition of LB's government and municipal finance (Nicholson & Pastor 2008). LB's financial expertise and access to financial resources enabled innovation, exemplifying Clegg's (1989) facilitative circuit. The financial techniques necessary to undertake the fundraising for the State of Alabama were not well understood (Nicholson & Pastor 2008). Any bond issue for a southern US state which was defeated in the Civil War required not only an acute assessment of the risk of the State's relatively poor financial condition but also an ability to market the bonds as a safe investment to potential investors. This process can be understood as a rare technology of production usually found in a facilitative circuit. The possession of this knowhow empowered LB to dominate the specific field of government finance during these early years.

This power emanated from the facilitative circuit where the funding needs of the state government created an opportunity for an investment bank to offer a solution. The firm's established relationships with the state government officials and its broader business network constitute the obligatory passage point needed to transfer power to the episodic circuit. LB's power was realised in the episodic circuit through the favourable business outcomes achieved from the ongoing business with the state government (Clegg 1989). LB's adaptability in changing strategy and adopting new businesses through the exercise of power using knowledge and relationships is evident during this period with the evolution from cotton trading to investment banking as a primary source of income after the Civil War.

In the years following the Civil War, railroad development assisted in the transformation of the US from an agrarian to an industrial economy (McPherson 1988, pp. 24-5). The boom in railroad construction generated an extraordinary need for capital which up until then was traditionally met by the equity capital markets. As mentioned in CHAPTER 4, the need for financing exceeded the capacity of the equity markets, and underwriters structured bond

issues in affordable parcels aimed at retail investors. These became known as railroad bonds. LB noted this trend and thus began to routinely engage in the selling and trading of these bonds (Geisst 2001; Nicholson & Pastor 2008).

The post-Civil War period was characterised by LB embracing the concept of profiting through trading various commodities. In 1870, LB was instrumental in the establishment of the New York Cotton Exchange⁴⁶. Due to the firm's role in the Exchange's formation, Emanuel was granted a membership of the Board of Governors which lasted until 1884. Soon LB began trading coffee and petroleum and was instrumental in the formation of the Coffee Exchange in New York in 1882 (Nicholson & Pastor 2008).

By this time, the firm was an established trader of commodities and debt securities and in 1887, realising that their trading and brokerage skills could apply to the trading of stocks, it became a member of the New York Stock Exchange. This development can be identified as the seminal moment in LB's history whereby the firm "completed its transformation from a merchandiser to a merchant banking firm" (Geisst 2001, p. 50). LB only gradually embraced the share issuance sector, waiting until 1899 to underwrite its first initial public offering for the International Steam Pump Company. Equity securities underwriting only became a mainstream line of business from 1906 under Philip Lehman, the son of Emmanuel Lehman (Geisst 2001, p. 51).

5.1.6 Retention of Power through Family Control

LB had a policy of admitting only direct family members as partners until 1924. Even in-laws couldn't aspire to partnership level. An example of this focus on bloodline partnership access is as follows:

John L. Loeb Jr. recalled that his father, who was married to Mayer's granddaughter Frances, couldn't get a job at Lehman Brothers when he wanted to work on Wall Street. They wouldn't hire any in-laws, and in fact for years I don't think there was even a descendant who had a name other than Lehman who got the job (Libo 2008).

⁴⁶ The New York Cotton Exchange later became the New York Board of Trade and in 2007 was renamed the ICE Futures US

Employing family members was a practice of many Jewish family-controlled firms. According to Supple (1998, p. 168) “nothing was more natural than to find a place for a relative”. The employment decisions were usually centralised with the patriarch, thereby maintaining their influence through a coercive control. “As long as decision-making could be concentrated...the personality of the head of the firm, his ability, his contacts and reputation - was all important” (Supple 1998, p. 170). Due to their religious faith and race, it is likely that being employed within a family-controlled firm may have been the only means by which a German-Jew could have gained a role in investment banking. Supple (1998, p. 170) asserts that “it is a remarkable feature of the rest of the financial world that other prominent firms never had Jewish partners”.

The policy of employing exclusively Lehman descendants was an attempt to retain power through fixing membership to relations, a characteristic of a dispositional circuit (Clegg 1989). Naturally partners outside the family would dilute the family ownership since partnership interests represent a share in the ownership of the firm. The majority membership of LB by Lehman family members ensured that power of the head of the firm was exercised in the episodic circuit. Although major decisions were often made by the head of the firm, they were often undertaken with some influence from other family members. This day to day decision-making reflects the social relations between family members to ensure the outcome was sympathetic to the ambitions of the head of the firm. Family control of the firm was thus safeguarded. The firm employed numerous family members over the years. A family tree showing the family members’ involvement is set out in Appendix B.

5.1.7 The Second Generation

After Mayer's death in 1897 and Emanuel's retirement shortly afterwards, a second generation of Lehman's – Philip, Sigmund, Arthur, Meyer H. and Herbert took over and steered the firm towards a pure investment banking business. Philip, the son of Emanuel, became a partner in the family-owned firm in 1887 and was the firm's managing partner from 1901 to 1925. As discussed in section 4.2.14, the Jewish firms preferred to work with each other in securities transactions. Philip continued this practice and in 1906 he formed an informal partnership with Henry Goldman, the leading partner in the Jewish firm Goldman Sachs, to exploit the flourishing securities market. The association between the firms allowed them to fulfil the funding requirements of many Jewish corporations involved in the retail, textile, and cigarette manufacturing industries. The two firms co-participated in several high profile securities underwriting transactions for corporations such as: Sears, Roebuck & Co.; F.W. Woolworth Co.; May Department Stores; Gimbel Brothers, Inc.; and R.H. Macy & Co. In this twenty year period to 1926, LB underwrote approximately one hundred new equity issues, very often in conjunction with Goldman Sachs (Geisst 2001).

5.1.8 Bobbie Lehman - Head of Lehman Brothers Partnership 1925 - 1969

One of the more notable and the longest serving LB managing partner of the 20th century was Robert (Bobbie) Lehman who took over the leadership position in 1925 and continued in this role until 1969. Family control was assured when Bobbie succeeded his father Philip Lehman, following Philip's death.

Figure 60 – Picture of Robert (Bobbie) Lehman



Source: (Barker Library Historical Collections 2012).

The first exception to the family member partner policy occurred in 1924 when John Hancock (a non-Lehman family member) was admitted as a partner. This represents the beginning of a more liberal management approach from the firm's new generation of leaders. Bobbie Lehman continued the firm's pioneering spirit by backing companies in emerging industries. This strategy was encapsulated in Bobbie's business philosophy that the future of US economic prosperity would be based on mass consumption and not on production. He therefore developed a strategy of identifying and financing growth industries. Some of these industries were involved in developing high technology applications. Companies supported by LB included Digital Equipment Corporation, Allan B. Dumont Laboratories the first television manufacturer, Radio Corporation of America (RCA) a pioneer in radio communications, and a number of corporations involved in the highly risky film and entertainment industries including RKO, 20th Century Fox and Paramount Pictures. Another example of the pioneering spirit of the firm at this time was the financing of a small airline, run by Juan T. Trippe, a fellow alumnus of Yale University. The service eventually became Pan American World Airways (Barker Library Historical Collections 2012). Bobbie Lehman directed the firm towards industries which more established firms considered to be too risky. The firm also continued to support the retailing industry where it had developed strong knowledge given its merchant trading background. The electronic and petroleum industries were considered high risk, emerging industries for financiers given the uncertainty surrounding the sustainability and longevity of the natural resource or technologies employed. This is another example of how LB's strategies allowed it to venture into high business risk activities in search of growth (Geisst 2001).

LB continued to search for ways of capitalising on the firm's knowhow and relationships within the various industries to which it was exposed. The Great Depression of the 1930s made it difficult for many corporations to raise capital. In response to this difficult capital market environment, LB developed an alternative yet adjacent business activity. This activity involved circumventing a public issue by issuing securities of corporations with a strong credit profile to investors directly and privately. The practice was known as a private placement and contained conservative loan terms and conditions to provide a tolerable level of risk and an acceptable rate of return for the lenders, whilst enabling borrowers to raise large amounts of much needed capital. Although this is a standard financing technique today it was quite innovative at the time. The continued use of this technique until the modern era represents a normative influence on the industry similar to the continued use of syndicates to share risk of large underwriting transaction as described in section 5.1.3. In both cases, the practice of offering a technique or financial product becomes institutionalised as it legitimises their role as experts with a breadth of skills.

Meanwhile, the company's political power was rising. Herbert H. Lehman, who had been a partner for two decades, was elected Lieutenant Governor of New York in 1928 under Franklin D. Roosevelt. He succeeded Roosevelt as governor in 1932 and served in that role

for 10 years. In 1949 he was elected to the US Senate, a post he held until six years before his death in 1963 (Cole 1984). By the early 1970s, after Bobbie Lehman and other key partners died, the firm found itself struggling to survive. Bobbie Lehman took LB from a modest sized firm to become one of the largest investment banks in the US. At the time of Bobbie's death there was no other Lehman family member employed by the firm and therefore there was no clear choice for a successor. In the four years following the death of Bobbie Lehman, the firm struggled under the leadership of Frederick Ehram, who had worked at LB since World War 2. However given the lack of Ehram's authority, the firm's performance suffered. Following a board coup in 1973, Ehram was removed as Chairman and replaced by Pete Peterson (Chapman 2010).

5.1.9 Peter Petersen – Chief Executive Officer 1973 - 1983

Figure 61 – Picture of Peter Petersen



Source: (Alchetron Encyclopedia 2015b).

Petersen is credited with reviving LB, turning it into one of the most profitable investment banking firms in New York, and establishing it as an internationally significant firm which often advised developing nations. During the 1950s and 1960s as the US economy experienced high levels of economic growth, the firm continued to prosper by financing the companies in the abovementioned risky segment of industrial sector. The early 1970s however coincided with the onset of a severe recession and by 1973, the firm's operating income was in decline. Petersen was previously US Secretary of Commerce from February 29, 1972 to February 1, 1973 and CEO and Chairman of Bell and Howell Corporation from 1963 to 1971. He was recruited to LB in 1973 with the titles of CEO and Chairman. This position of authority empowered him (subject to Board directions) to rescue the firm (Geisst 2001, p. 77).

Petersen was well connected, with associates at the upper end of New York society and within government departments. For example, he was often invited to fill casual roles in philanthropic and government organisations such as: in 1969 to the 'Commission on Foun-

dations and Private Philanthropy' where his invitation to join was at the bequest of John D. Rockefeller III, Council of Foreign Relations Chairman, John J. McCloy, and former Treasury Secretary, Douglas Dillon. The Commission became known as the "Peterson Commission" (Brookhart 1998, p. 2); and in 1971 to the role of Assistant to the President for International Economic Affairs by US President Richard Nixon (Council on Foreign Relations 2016). Petersen's influential network within political spheres, which he successfully utilised throughout his business career, was well established by the time he joined LB. Petersen's humble upbringing produced an empathetic quality which was well recognised in Washington and New York and merited a vast network of useful contacts. Malloch and Mamorsky (2013, p. 33) describe him as "warm, thrifty and a Wall Street outsider, having grown up in Nebraska, the son of Greek emigrant shop-keepers, it was his entry into Wall Street".

Petersen inherited a significant challenge when he joined LB in the early 1970s. NYSE seat⁴⁷ prices had reduced significantly and in 1975 rules were introduced to cease the practice of charging minimum fixed commissions. Introduction of this rule coincided with a drop in trading volumes resulting in a significant reduction in NYSE seat prices from USD138,000 to USD35,000 over a two year period to 1977 (Barrett 1999). This prompted a discounting war amongst brokers, which placed further financial pressure on firms. Furthermore, Wall Street faced increased competition in its traditional fields from a variety of sources. Some industrial corporations began to underwrite their own issues. Mergers and bankruptcies had driven the number of NYSE member firms down from the 1960s high of 681 to 490 in 1975 (Kepos & Derdak 1994).

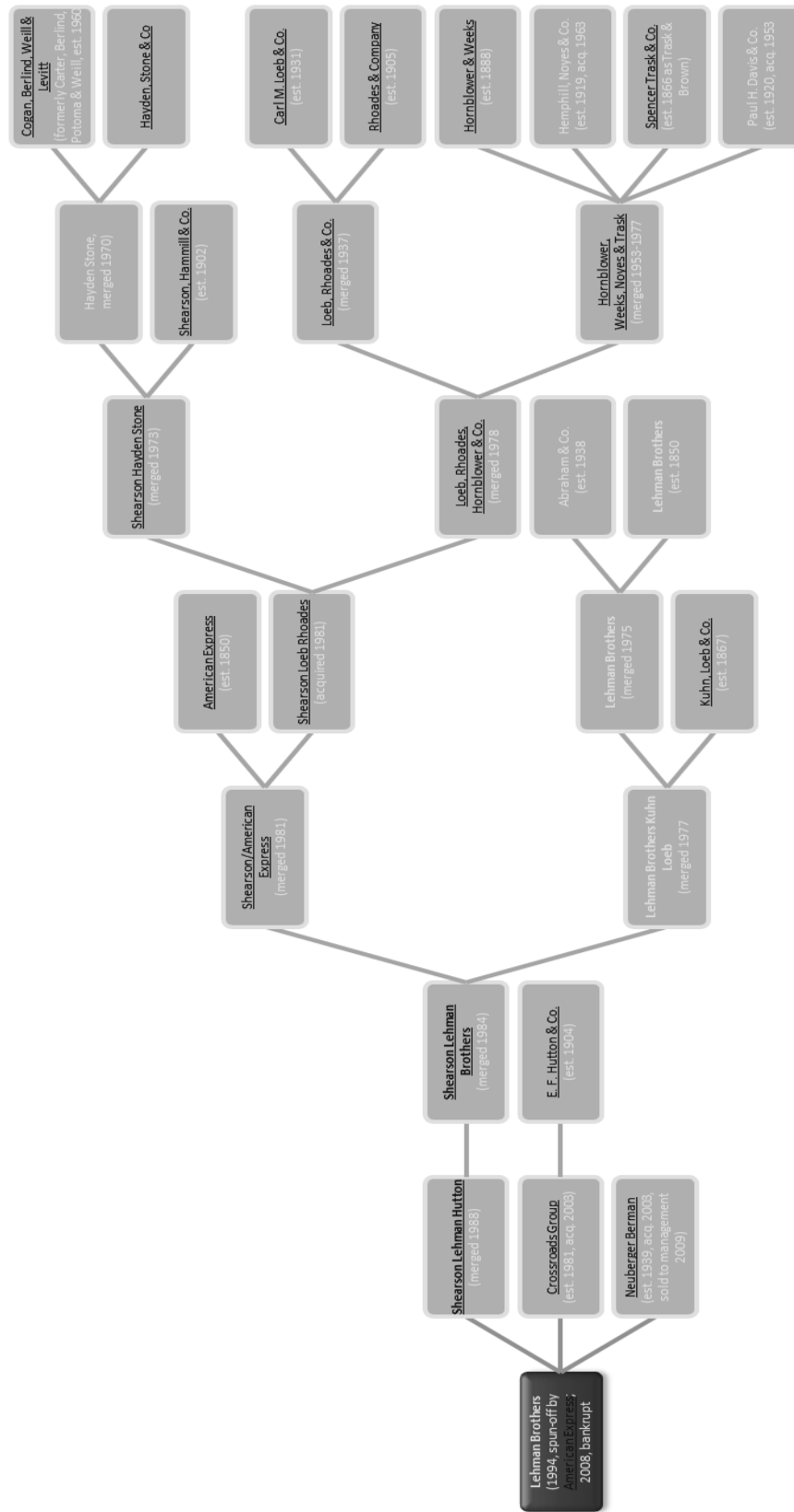
Petersen immediately set about formulating a strategy for a turnaround which involved expansion and diversification of products offered. Petersen restructured the firm's product base by focusing the firm's activities on capital markets trading with an emphasis on commercial paper trading in an effort to restore the firm's profitability. Petersen's ultimate successor, Lewis Glucksman was charged with building the Commercial Paper Division. See section 5.1.10 for a background of Lewis Glucksman.

⁴⁷ A seat on the New York Stock Exchange was a membership right to trade on the floor of the New York Stock Exchange either for the personal account of the owner of the seat or on behalf of a client. Seats had a value and could be traded subject to meeting the stock exchange's qualifying criteria. Ownership of a seat conferred a level of prestige, especially during the 19th century. The seat system ceased in 2007 once electronic trading was introduced on the exchange.

Many firms dealt with the downturn in revenues by merging operations. Under Petersen's leadership the firm merged with Abraham & Co. in 1975 and Kuhn Loeb & Co in 1977. The firm was renamed to reflect the enhanced domestic and international business lines. Whilst Lehman Brothers, Kuhn, Loeb Inc. was the business name of the US operations, Kuhn, Loeb, Lehman Brothers Inc. was the business name for its offshore operations reflecting the dominance of Kuhn & Loeb's international presence. "The merged entity was the country's 4th largest investment bank behind Salomon Brothers, Goldman Sachs, and First Boston" (Sloane 1977).

Kuhn Loeb & Co was one of the country's pre-eminent investment banks which had also forged its reputation on financing the railway developments of the 19th century. However like many of the other New York firms, it too was struggling during the 1970s. Abraham & Co was a smaller family owned stock broking firm. As a result of these mergers, LB was able to turnaround its performance. "Peterson led the firm from significant operating losses to five consecutive years of record profits with a return on equity among the highest in the investment-banking industry" (Geisst 2001, p. 78).

Figure 62- Chart Of Mergers And Acquisitions Forming Lehman Brothers Inc



During the 1980s Petersen steered the firm to become increasingly involved in the emerging high tech industries of personal computers and biotechnology by backing their fund raising activities. This strategy represented a continuation of direction fostered by Petersen's predecessor, Bobbie Lehman who focused on seeking out new markets where small organisations could, with the expertise of design, engineering, new applied research and programming, develop into large companies.

Merger and acquisition activity increased in the 1980s as US corporations moved to expand both domestically and internationally. LB followed this trend by participating in the associated advisory services needed to consummate these transactions. LB "advised on several notable US and cross border merger transactions including those between Bendix and Allied, Chrysler and American Motors, General Foods and Philip Morris and Genentech and Hoffman-LaRoche. Furthermore LB increased its underwriting activity under Petersen and managed a total of 130 deals from 1973 to 1983" (Barker Library Historical Collections 2012). See Appendix C for a full list of deals undertaken by LB. Petersen's legacy as a turnaround expert lasted into his later years during which he co-founded the private equity firm, Blackstone Group. In 2008, Peterson was ranked 149th on the 'Forbes 400 Richest Americans' with a net worth of USD 2.8 billion and had subsequently in 2012, been named the most influential billionaire in US politics (Hiltzik 2012).

5.1.10 Lewis Glucksman Chief Executive Officer 1983 – 1984

Figure 63 - Picture of Lewis Glucksman



Source: (Valuestockplayers.com 2015).

Lewis (Lew) Glucksman joined LB in the Commercial Paper Trading Department in 1963. "He graduated from the College of William and Mary and later earned a Master's degree in business administration from New York University" (Onaran & Baer 2006).

Although the Investment Banking Division within the firm gained much prestige associated with its advisory roles, the Trading Division which was later headed by Lewis Glucksman was still generating the majority of income for the firm. Peterson, having a reputation as a dis-

tinguished banker, had traditionally supported the Investment Banking Division whose share of LB's profits was declining, generating in 1983 less than a third of the firm's profits against the approximately 60% generated by Glucksman's Trading Division (Auletta 1985; Fishman 2008). However partners from the Investment Banking Division still held 60 percent of LB's stock, and constituted 42 of the firm's 77 partners (Auletta 1985).

Consequently by the early 1980s serious friction emerged between the Investment Banking Division and the Trading Division. In order to reconcile the disparity between the profit contributions of the two divisions and their respective representation in senior management, Petersen promoted Lewis Glucksman, the representative of the Trading Division to be a Co-Chief Executive Officer (CEO) of LB in 1983. Glucksman asserted his authority and quickly made changes to favour the traders. This reignited hostilities between the warring factions and coupled with the 1983 declining stock market, a battle for management control ensued between Glucksman and Petersen. According to Geisst (2001, p. 78) the struggle ended with Glucksman taking control as the sole CEO, "and just like that, the traders were in charge" (Fishman 2008, p. 3).

Use of Power to Ascend to Leadership

This ascension to the sole leadership position was akin to a coup, where a power struggle eventually favoured Glucksman:

Hostilities between the firm's investment bankers and equity and commodity traders caused internal strife. An ex-Chairman of the firm's M&A committee recalls in an interview that Lehman Brothers had an extremely competitive environment which ultimately became dysfunctional (Ryback 2010).

This was the first time in the history of LB where such a hostile coup had taken place and signalled the beginning of the overt appetite for power by a non-family member of the LB leadership team. Glucksman's aggressive nature had driven him to corral support from other partners (Auletta 1985). In terms of Clegg's (1989) circuits of power, Glucksman undertook concerted action to effect change by communicating the contributions of the Trading Division to the partners and through clandestine meetings of senior management had sought sanction for his action (Geisst 2001). His influence over fellow partners was manifested through his position of Co-CEO.

Glucksman's influence began in the dispositional circuit, where he used his senior position in the hierarchy of the firm to disseminate communication in a compelling way to address conflict amongst the two camps of traders and investment bankers (in this chapter investment bankers refers to those employees involved in the advisory side of the business, that is, from the non-trading division). Glucksman's position of Co-CEO enabled him to exercise power over other subordinate partners to force them to do what they otherwise would not.

Glucksman's authority was legitimised not only through his position of authority but also through the Trading Division's successful track record and recent profit contribution which exceeded that of the Investment Banking Division. Partners could not ignore that the future of LB was inextricably reliant on the continued profits from the Trading Division. An increase in profits translated to higher income for the partners - a motivation of self-interest. However, for this power to be effective, the process of organising must be present (Boje & Rosile 2001). In this instance the organising was taking place during clandestine meetings with senior management, which can be viewed as the passage point between the dispositional circuit where Glucksman's power was generated and the episodic circuit where Glucksman was perceived as the influencing agent over other partners and where the decision was made to elevate Glucksman to the sole CEO position.

The process of Glucksman's exercise of power through the episodic circuit took place during a temporary downturn in the market for investment banking services. This background constitutes an environmental contingency consistent with Clegg's (1989) facilitative circuit. According to Boje and Rosile (2001), the facilitative circuit is a major conduit of variations in the circuits of power, and the market downturn conferred the necessary power to Glucksman as partners searched for a way to emerge from the gloomy market conditions, thereby looking to leadership change as a possible solution. From the external environment described by the facilitative circuit, Glucksman was empowered.

The overt exercise of power by Glucksman had established a pattern of acceptable behaviour for the future CEO, Richard Fuld, who had worked under Glucksman for most of his career. See section 5.2 for a discussion of Fuld's behavioural traits. Eventually, Glucksman's assertive management style would generate a degree of animosity amongst a cohort of investment bankers, which would eventually diminish his power within the firm (Geisst 2001).

5.1.11 The American Express Takeover

Disaffected investment bankers left the firm and amidst this disintegration, Glucksman resorted to selling the firm. He left LB following the sale and continued his career several years later with Smith Barney, later to become part of Citigroup. The partners sold the firm to Shearson American Express, a wholly owned subsidiary of American Express. Shearson American Express found the business activities of LB to be complimentary to its own which focused on brokerage activities rather than investment banking (Cole 1984). The acquisition was considered significant at the time with Shearson American Express paying USD 360 million for LB in 1984. The combined firm became known as Shearson Lehman American Express (Cole 1984). By 1990 Shearson Lehman Brothers, the investment banking arm of the Shearson Lehman American Express conglomerate, split its operations into a Shearson Retail division and a LB Investment Banking/Trading Division, whilst under continued ownership of the American Express group. At the time of this split, Richard Fuld assumed joint leadership

of the Investment Banking/Trading Division with J. Tomlinson Hill, who headed the Mergers and Acquisition Division (Halpern 2011). The two executives were involved in a power struggle. Ultimately Fuld manoeuvred his way to become the sole CEO when Hill eventually departed in 1993 to join Petersen in the well-known private equity firm, Blackstone group (Halpern 2011).

Following the LB acquisition by the American Express group, there were some major management changes. An important appointment was that of Peter Cohen, who became the Chairman and CEO of the Shearson Lehman American Express division of the American Express group (Forbes.com 2011). American Express had for several years during the 1980s and early 1990s been pursuing a financial services diversification strategy which involved several major acquisitions. The first involved the acquisition of the second largest brokerage firm in the USA, Shearson Loeb Rhoades in 1981 to establish the group's brokerage arm to be known as Shearson American Express. (Geisst 2001). In 1984, the American Express group acquired Investors Diversified Services. The firm had been established for 90 years and consisted of a valuable team of financial advisors and a wide range of personal financial products. Shearson American Express then purchased E.F. Hutton & Co., another well-established securities firm dating back to 1904 and changed its name to Shearson Lehman Hutton Inc (Cole 1987).

5.1.12 Harvey Golub – CEO, American Express

Figure 64 - Picture of Harvey Golub



Source: (Alchetron Encyclopedia 2015a).

In 1993, American Express, under its new Chairman, Harvey Golub, undertook a reversal of the previous strategy in an effort to improve its performance during an economic cyclical downturn and reduce its exposure to the securities industry. The financial conglomerate disposed of its retail brokerage and asset management operations known as Shearson to Primerica which merged it with its own retail brokerage business, Smith Barney, to form Smith Barney Shearson (Quint 1993). Soon thereafter in 1994, American Express divested

itself of Lehman Brothers Kuhn Loeb. This was effected by way of an initial public offering (IPO), with the result being a new entity to be known under its final name of Lehman Brothers Holdings, Inc. (Geisst 2001). LB was now independent of any parent company and answerable to its own public stockholders. LB continued to operate in many of the same business lines that it had done previously with a continued focus on mergers and acquisitions and trading. The focus between the two main areas of business would vacillate in the ensuing years depending on the economic circumstances and the firm strategy as dictated by Richard Fuld. A table listing the leadership of LB over the years since its inception is set out in Figure 65.

Figure 65 - Leadership of Lehman Brothers 1850 - 2008

Period of Leadership	Leader	Summary
1850 - 1906	The Lehman Brothers	The founders who established an Alabama based dry-goods store and a New York headquartered commodity - brokerage
1906 - 1925	Philip Lehman	Expanded LB from a commodities business to an investment bank involved in new securities issues
1925 - 1969	Robert 'Bobbie' Lehman	Steered LB through the Depression by focusing on venture capital and supported innovative corporations in new industries. Managed LB through a prosperous period.
1969 - 1973	Frederick L. Ehrman	An interim Managing Partner
1973 - 1983	Pete G. Peterson	A well credentialed corporate executive who was employed to rescue LB. He led LB to become the fourth-largest US investment bank.
1983 - 1984	Lewis Glucksman	Ousted Peterson, by pursuing a greater influence for the Trading Division which accounted for the bulk of the profits. Subsequent poor performance led to the acquisition by American Express.
1984 - 1990	Peter A. Cohen	Cohen was the head of American Express. Fuld assumed the leadership once LB was listed by American Express.
1994 - 2008	Richard Fuld	CEO until its bankruptcy.

Source: (Fishman 2008).

5.1.13 Summary and Discussion

The pre-Fuld era spanning the period from the founding of the firm to the listing on the NYSE witnessed various episodes of tumultuous change. However despite the rollercoaster ride of fortunes and leadership, from a historical perspective, the firm endured a parallel course with the investment banking industry. The underlying themes affecting the investment banking industry discussed in CHAPTER 4 are analogous with those evident in the development of LB. Similar to the industry at large, the penchant to develop personal relationships with government authorities and officials, the influence exerted by investment bankers through their networks, and the thirst for power internally and over external parties, imbued the organisational culture of LB. A summary of the parallels examined in this section are set out below.

Networks and Connections with Government

The effective use of networks by LB began with the founders who exploited the Jewish connection and the influence gained through Emanuel's directorships of other corporations and membership of official institutions such as the New York Cotton Exchange. The Jewish network was helpful in obtaining commercial advantage through free trade credit and later by the club arrangements with other Jewish investment banks, whereby co-participation in one another's deals protected a segment of the market from external competition.

The extent to which the Lehman brothers pursued acceptance by New York society to further their ability to penetrate the valuable commercial and social networks included changing their names and relocating their business premises to be close to their associates and competitors. The normative influence which spurred these actions only succeeded in cementing their key relationships, and therefore enhanced their power base. The emphasis on nurturing networks to facilitate further business and gain favour was no different for subsequent generations. This was evident in the 1970s, when the family appointed well networked Petersen as the new CEO, in the hope that the combination of his business acumen and valuable corporate and political connections could turnaround the firm's fortunes during difficult times.

The value of political connections is also demonstrated when LB was appointed as the financial advisor to the State of Alabama. This achievement coincided with the first bond issue for the State following the Civil War. The bond issue presented a challenge given the poor financial condition of the State which was caused by the war. Therefore the transaction required particular knowhow and skill in arranging the bond structure and in convincing potential investors of the merits of the issue. Again this knowhow differentiated LB from its competitors, which positioned the firm to be unique as a provider of the structuring needed by the State. The knowhow therefore became the factor which empowered LB to gain fur-

ther favour from the government. The abovementioned networks provided the firm with the influence to entrench itself in the commercial world and expand its business interests domestically and internationally. The networks were ultimately a means of generating power to facilitate the outcomes desired by the stockholders and management.

Risk Taking and Innovation

The concept of taking elevated risks to generate a commensurate return was a concept well understood by the firm, and entrenched as a cultural behaviour by the founders. The Lehman brothers realised early the benefits of warehousing inventory. This innovative practice introduced risks associated with the exposure to a volatile price for cotton which could have resulted in losses magnified by the large volumes of inventory held, but also provided the potential for enhanced profitability. It also facilitated a degree of power within the cotton industry as the warehousing strategy enabled LB to meet customer demand, take advantage of pricing cycles and even control the supply of commodities such as cotton.

The extending of credit to farmers, who themselves represented risky credit due to the uncertainty of the quantity and quality of harvests, was innovative by way of accepting repayment in the form of cotton bales. This practice represented an extension of the firm's previous experience of bartering general merchandise from their store in exchange for cotton goods from the public. Other evidence of the risk taking culture exhibited by the founders included the running of the Union blockade during the Civil War, where their merchandise was at risk of piracy, ship damage or loss, or even confiscation by the Union army.

The risk culture established by the founders continued to the Philip and Bobbie Lehman eras. During these years LB was involved in servicing corporate clients by underwriting their securities issues. Both Philip and Bobbie pursued a strategy of supporting nascent industries such as the film, petroleum, high technology and biotechnology industries, in which corporations were less well established and therefore posed greater credit risks. However the commissions earned for these transactions were also higher and linked to the riskiness of the exposures to the corporations. Coupled with this type of risk taking was the innovative approach to fundraising, which was developed by establishing the first private placement. Again the innovation displayed allowed the firm to meet a financing need whilst enhancing their profitability through higher commissions and a degree of market power which was well exploited.

Power and the Distortion of Culture

The exercise of power was an effective means of promoting the business and retaining control by the firm's leadership. The policy of restricting the appointment of partners to family members was an example of this type of power. It was not until decades after the formation of LB that a non-partner was admitted, and this was due to commercial necessity and a

thinning of the Lehman ranks. Control was seen as important in pursuing personal goals as much by the Lehman family as it was for Richard Fuld. However in the latter years of the pre-Fuld era, the exercise of power by certain individuals promoted episodes of dysfunction within the ranks of senior management. Firstly the internal struggle for power between Glucksman and Petersen ended with the acrimonious departure of the latter CEO. Then Glucksman departed after resorting to selling the firm following a virtual revolt by the other partners. This was followed by another similar pursuit of power by Fuld when as Co-head of the Investment Banking and Trading Division, he ousted fellow Co-head Tomlinson-Hill to assume the sole leadership position of the division.

This overtly aggressive culture continued over after Fuld was appointed CEO and Chairman – being the post-Fuld era. Fuld, whose tenure with LB overlapped both the pre-Fuld and post-Fuld periods, was able to assimilate the behavioural traits exhibited by his mentor, Glucksman. He was therefore able to transmit the observed experiences of social interactions within the firm and able to further mould the organisational culture to match his own personal objectives and values. The following section outlines the key personalities within LB during the post-Fuld era and analyses how Fuld was able to exert his influence throughout the firm by using subordinates as instruments of his design or according to Clegg (1989) as his ‘obligatory passage point’ in the quest for power.

5.2 The Post-Fuld Era (1994 – 2008)

This section examines the history of the firm from the time Fuld ascended to the leadership position of CEO and examines the impact of some key events during this period on the development of the firm’s business activities, corporate culture and relationships within and external to the firm. The post-Fuld era is considered the period in which the beginning of LB’s downfall was rooted. This period was characterised by the appointment of like-minded individuals who followed Fuld’s mantra of ‘growth at all costs’ and a risk appetite clearly higher than had been prevalent in the past. The growth of LB during this period also coincided with the growth in innovation in financial products, corporate activity, and financial markets trading volumes. Whilst investment banking firms experienced significant growth, the partners in firms were well rewarded and found comfort in their job security. This environment was conducive to a general state of satisfaction in leadership which ultimately engendered a degree of hubris which was found evident at LB. Refer to CHAPTER 6 for evidence of hubris in the last days of LB.

5.2.1 Richard Fuld

Richard Fuld was born in 1946 and began his career in the US air force as a pilot (Bawden

2008). Fuld then moved to LB in the Trading Division as a commercial paper trader in 1969. Glucksman, similarly a trader by background, was the head of that division at the time and had become a major influence and mentor to Fuld. By the 1980s Fuld was promoted as head of the Fixed Income and Equities Division. This was known as a significant role heading a core activity of the firm (Halpern 2011). He served as CEO of LB from the time of its spin-off from American Express in 1994 until December 31, 2008. Since joining the firm, Fuld's career with LB had spanned 30 years. An extract from LB's prospectus reveals that at the time of LB's bankruptcy Fuld held numerous positions outside of the firm. Fuld served on:

the Board of Directors of the Federal Reserve Bank of New York and is a member of the Executive Committee of the Board of Directors of The Partnership for New York City. He is a member of the International Business Council of the World Economic Forum and The Business Council. In addition, he serves on the Board of Trustees of Middlebury College and New York Presbyterian Hospital, as well as on the Board of Directors of the Robin Hood Foundation (Lehman Brothers Holdings 2008j, p. 48).

His roles with the Federal Reserve Bank of New York and International Business Council of the World Economic Forum provided him access to numerous influential executives in the regulatory and economic policy fields. In 1984 American Express acquired LB and folded the firm in with the Shearson business which was acquired in 1981. The combined division was known as Shearson Lehman Brothers which operated three divisions: investment banking, equities and fixed income (Halpern 2011). In 1990 the consolidated Shearson Lehman Brothers division, which at the time operated under the American Express corporate umbrella, split its operations into two divisions: a retail division under the name of Shearson; and Lehman Brothers Investment Banking/Trading Division (Halpern 2011). As mentioned in section 5.1.11, Fuld became Co-CEO of the Lehman Brothers division, sharing the title with J. Tomilson Hill, who he finally ousted to assume the sole leadership position of the division.

Figure 66 - Picture of Richard Fuld CEO of Lehman Brothers 1993 - 2008



Source: (Daily News 2010).

Fuld was a very successful trader within the Fixed Income Division, however perceptions of his interactions with co-workers were decidedly limited throughout his career (Halpern 2011). As a manager, Fuld was severe and exacting. He is quoted as saying “I take it as a personal failure to lose money”(Fishman 2008, p. 3). In addition Fishman (2008, p. 3) claims that Fuld managed by intimidation “he thought he could intimidate you out of losing money”. A notorious temper earned Fuld, who had been a weightlifter, the nickname of "gorilla" (Tully 1995). Fuld possessed a “palpable inner intensity, which give him an almost animalistic presence...[and]...made it seem like [a situation] will lead to physical violence if you didn’t relent” (Fishman 2008, p. 1).

As Fuld’s direct manager for many years, Glucksman became an influential role model to him. Fuld’s Jewish middle class background differed from Glucksman’s, who was resentful of the typical ivy-league educated investment bankers from the non-trading division whom he often referred to as “Fucking bankers” (Fishman 2008, p. 3). Investment bankers as opposed to the traders were often perceived as elitists within the industry who commanded intellectual superiority. Traders such as Glucksman and Fuld were transaction focused and prided themselves on generating quick profits which didn’t rely on time consuming relationship building (Auletta 1985). This perception was based on the functions performed within the business. Glucksman was confrontational towards investment bankers, with authority and indignation. Glucksman’s outbursts became legendary within LB. “In a rage, he once ripped the shirt off his own back and Fuld followed in the master’s footsteps” (Fishman 2008, p. 4).

Fuld readily accepted Glucksman’s behaviour as normal within the Trading Division where an aggressive attitude be-fitted the image commonly portrayed in that environment. Traders were expected to make profits from betting on price movements of financial instruments and were required to beat their counterpart in the fast paced deal-making. Trading activity was considered combative and a weak demeanour was perceived as undesirable. Fuld understood the importance of sustaining a strong willed appearance in the trading room environment. He enjoyed being referred to as ‘the gorilla’ and positioned a life-size image of a gorilla in his office near the trading floor (Fishman 2008). This behaviour is evidence of an aggressive corporate culture where dysfunctional behaviour was mimicked and condoned.

Fuld’s nature can be traced to the early years of his career. He graduated with a Bachelor of Arts and Bachelor of Science from the well regarded University of Colorado and a Masters of Business Administration from New York University’s Stern School of Business, one of the prominent business schools in the US. Following his studies, Fuld entered the US Airforce to train as a pilot. However he was soon dismissed for engaging in a violent altercation with his commanding officer (Bawden 2008). The grounds for his dismissal represent early evidence

of Fuld's aggressive nature and willingness to sacrifice such a valuable opportunity, being his air force career, on an impulse.

As CEO in 1994 Fuld was faced with a challenging task. When American Express group CEO Harvey Golub sold its retail brokerage and asset management operations known as Shearson to Primerica and then divested of Lehman Brothers Kuhn Loeb through an IPO, he sought to extricate the large financial group from the volatile brokerage business. In the process he burdened LB with significant financial liabilities. Under the arrangements of the approximately USD 2 billion initial public offering (IPO) in 1994 American Express had transferred to LB potentially damaging liabilities for a number of failed limited partnerships. American Express had also contracted to receive some of LB's future profits and for LB to lease vast areas of floor space owned by American Express under long term leases. These arrangements were designed to improve American Express' return on its original investment in Shearson/Lehman 10 years earlier. Immediately following its IPO, LB's shares were trading at less than book value (Tully 1995).

5.2.2 Fuld's New Team

Fuld needed to react to the markets' negative perceptions of LB following the American Express disposal and set about forming an inner circle of executives who shared a similar background, both intellectually and socially. Fuld sought out executives who shared common attributes, such as an ambition to succeed. Fuld refused to appoint a deputy for 8 years. His reluctance to appoint a natural successor may be due to his experience of observing the struggle for leadership between Peterson and Glucksman. Fuld soon undertook a management restructure which entailed replacing the heads of the three main divisions of investment banking, equities, and fixed income. One of Fuld's first tasks was to prioritise investments into the best performing business division. Notwithstanding his contempt for the Investment Banking Division which he inherited from Glucksman, the mergers and acquisitions department (part of the investment banking team) generated the highest margins within the group. He therefore directed most of the firm's investments to this activity, also supporting the equities department by recruiting several expensive candidates. This restructure increased the firm's risk profile as the Mergers and Acquisitions and Equities Trading Divisions were highly subject to fluctuations in economic conditions (Halpern 2011). Fuld's commitment to surround himself by high achievers is reflected in the compensation he was prepared to pay to new recruits:

In January 1997 Fuld approved USD 48 million for additional executive compensation. From this amount, USD 46 million was earmarked for the Investment Banking, and Equities Divisions, with USD 2.4 million for the Fixed-Income Division. Fuld's strategy was to clearly reposition LB away from its traditional reliance on fixed income (Halpern 2011).

This strategy shows that Fuld, as an ex-division head of fixed income, didn't allow sentimentality to interfere with a business strategy that he preferred to pursue. Fuld revealed in a speech in 2007, that he disliked disagreements amongst his senior management, emphasizing that a team approach to a common goal was the attribute he most desired in an employee. "The most dissension [Fuld] will tolerate is an agreement to disagree. What [Fuld] needs is peace in the family" (Wharton School of the University of Pennsylvania 2007). Fuld selected key employees who like himself, exhibited initiative. He therefore placed importance on leading by example. "Real power is the ability to empower others...a good leader brings out the best in others. The real reward is in seeing others' achievements" (Wharton School of the University of Pennsylvania 2007). The result was a team that largely consisted of individuals that shared similar leadership qualities with Fuld and therefore a propensity to make similar management decisions.

An avid squash player, Fuld preferred to recruit executives with a background in sport. "They know how to compete and lose, how to pick themselves up and go on to win again" (Wells 2004). Bonuses were largely paid in shares and for the executive committee were vesting after five years, in an effort to retain successful employees who had large bonuses accrued. "You had to decide whether you were going to stay and try to make this work. A lot of people left" (Fishman 2008, p. 3). For those who remained, Fuld was able to generate intense loyalty, especially from the group of colleagues who followed his rise through the Fixed Income Division. A brief description of Fuld's inner circle is set out below. Individuals selected were executives either on the executive committee or former heads of one of the key divisions or were influential in the leadership of the firm. They were influential in the formation of the firm's culture in the immediate years prior to LB's bankruptcy, and were therefore implicit contributors in the financial decline of the business. An overview of their backgrounds is necessary as they feature in the analysis of power undertaken in this thesis.

5.2.3 Chris Pettit – Chief Operating Officer

Figure 67 - Picture of Chris Pettit – Chief Operating Officer LB, 1996



Source: (West Point Association of Graduates 1997).

Chris Pettit - President and Chief Operating Officer (COO) worked under Fuld for twenty years. As a long-serving deputy, he was trusted by and worked closely with Fuld. Pettit, a graduate of West Point, served as a captain in Vietnam and was described as a high achiever considering his numerous accomplishments - twice all-American leading scorer, and captain of the lacrosse, football and basketball teams at Westpoint and named to the Long Island Lacrosse Hall of Fame (West Point Association of Graduates 1997). Fuld relied heavily on his second in charge to run the business on a day to day basis and therefore Pettit held the most important and influential position after that of CEO. Pettit, a loyal employee of LB had a personal objective similar to that of Fuld:

to wind Lehman back closer to how he found it in 1977 when he signed on as a young salesman fresh out of teaching math in junior high school - a proud institution run by loyal partners. It's not a job, he seems to believe it is his destiny. 'Many, many years from now,' he says, 'I want my name etched in granite in the corridors of Lehman (Tully 1995, p. 1).

On 15 March 1996 Pettit resigned under circumstances which were kept confidential at the time, however later in a public announcement by the firm it was disclosed the resignation was due to his disagreement over the direction of the company (Truell 1997). In reality, Fuld had discovered that Pettit had an extramarital affair which violated Fuld's unwritten rules on marriage and social behaviour (Truell 1997). Even as a loyal lieutenant, Pettit couldn't be protected from the drastic reaction of the firm to publicly distance itself on grounds of a personal matter occurring in a private domain. Despite the embarrassing circumstances surrounding Pettit's resignation, it was reported that "friends and colleagues of Mr. Pettit said he eventually had a falling out with Richard S. Fuld Jr., the Chairman and CEO, over whether Lehman should be run by a committee or by one strong figure like Mr. Pettit" (Truell 1997). Pettit, a strong leader, obviously garnered significant support from his team and friends and appeared to pose a challenge to Fuld's overarching leadership. The true reasons for Pettit's resignation can therefore only be presumed however either way it represented the removal of a key executive that no longer fitted in within Fuld's newly constructed organisation. Christopher Pettit died one year after his resignation in 1997 due to a snowmobile accident, at the age of 51 (Truell 1997).

An Exercise of Power

Pettit's ousting is an example of the way Fuld's personal beliefs and values were inculcated into the firm's decision-making framework. Not only did Fuld exercise his power through Clegg's episodic circuit by the act of Pettit's dismissal, which imposed his own values and beliefs on the firm, he managed to influence the firm's culture through the dispositional circuit of power which constitute the rules of the firm. The dismissal sent a clear signal to all staff that extra marital affairs would not be tolerated and thus became a 'rule of practice'.

Fuld replaced Pettit in 2002 with Bradley Jack and Joseph M. Gregory. Jack was soon demoted to head up the firm's investment banking relationships and left in June 2005 with a redundancy package of USD 80 million, leaving Gregory as the sole COO (National Public Library 2016). Bart McDade, previously in the position of head of equities, replaced Jack and continued in this role until the collapse of LB.

5.2.4 Bradley Jack Co-Chief Operating Officer

Figure 68 - Picture of Bradley Jack



Source: (Dolmetsch & Dillon 2011).

Fuld's cronyism is exemplified by favouring individuals from the Trading Division, where his own career had been established and where individuals mostly shared values similar to his own. Jack commenced with LB as an associate in the Fixed Income Division in 1984 after completing his Bachelor of Arts from the University of California. He soon became the head of the Fixed Income and Global Syndications Division, and later ascended to the role of Head of Investment Banking in 1996 in which he remained until 2002. There is little other information about Jack's involvement in LB including the circumstances around his demotion. However according to a statement issued by Fuld, Jack retired in 2005 to pursue work in the non-profit sector and spend time with his family (Carmiel 2012).

In 2011, well after he retired from the firm, Jack, then 53, turned himself in and was charged with second-degree forgery for an incident at a pharmacy in which he faked the date on a doctor's prescription for a controlled substance (Dolmetsch & Dillon 2011). A further testimony to Jack's character is that he was forced to sell his home after having failed to pay property taxes on his property estate. The tax matter was resolved eventually, and the property was sold for USD 62 million in October 2013 (Budin 2013). "He is the most delinquent taxpayer," Gorzelany town tax collector said in a telephone interview (Carmiel 2012).

5.2.5 Joseph Gregory - Chief Operating Officer

Figure 69 - Picture of Joseph Gregory



Source: (DeCambre 2009).

Joseph Gregory was appointed President and COO in 2004 after sharing that position with Bradley Jack since 2002. Like Fuld, Gregory joined LB as a commercial paper trader following the completion of his Bachelor of Business Administration in 1974 at Hofstra University, New York and was an employee of LB until its collapse (Fitzgerald 2009). Gregory held several management positions from 1980 to 1991 and from 1991 to 1996 he became Co-Head of the Fixed Income Division. He moved to head the Equities Division from 1996 to 2000 and from this time until 2002, he was the Chief Administrative Officer.

Gregory complemented Fuld and openly declared he had no interest in the CEO position. "He was known as 'Mr. Inside' (Fuld was known as 'Mr. Outside'), and ran the firm operationally on a daily basis" (Fishman 2008, p. 4). Gregory delivered Fuld's objectives and focused on generating a culture of team outperformance believing this was the key to success. As explained by a former executive, it was Gregory's view that "If you got the people and the culture right, they would run the firm day-to-day in a great way" (Fishman 2008, p. 4). Gregory was also reported as saying "Trusting your instincts, trusting your judgment, believing in yourself...and making decisions on the back of that trust is a remarkably powerful thing" (Fishman 2008, p. 4). This is considered a telling comment from the second in charge of a sophisticated investment bank. Common wisdom in management literature promotes rational decision-making, a process where decisions should be made on an informed basis using all information and resources available as opposed to the use of instincts. Instincts and personal judgement as opposed to informed decision-making was a common trait amongst traders at LB (McDonald & Robinson 2009). Gregory was replaced by Bart McDade, shortly before the bankruptcy (Truell 1996). See section 10.4.3 for a discussion of Gregory's dismissal.

5.2.6 Thomas Russo – Chief Legal Officer

Figure 70 - Picture of Thomas Russo



Source: (Equilar Atlas 2008).

Since the early days of LB following the American Express sign-off, Thomas Russo held the position of Chief Legal Officer at the management level of Executive Vice President. In this role he became a member of and counsel to the firm's executive committee. Prior to joining LB, Russo was a senior partner at Cadwalader, Wickersham & Taft (CWT), a New York law firm. His interests also lay in institutional and regulatory authorities such as: The Institute for Financial Markets where he was Vice Chairman of the Board of Trustees; The Regulatory Policy Committee of the Board of Governors of the Financial Industry Regulatory Authority (FINRA)⁴⁸ where he was a member; The Federal Reserve Bank of New York where he was on the International Advisory Committee; and member of the Committee on Capital Markets Regulation (Equilar Atlas 2008). Russo was well known within regulatory circles given these roles and during his time at CWT, he specialised in corporate law, Commodity Futures Trading Commission (CFTC) matters, SEC enforcement and broker-dealer operations. His interest in regulation was formed in the early part of his career when from 1969 to 1971 he was a lawyer in the market regulation division of the Securities and Exchange Commission and

⁴⁸ FINRA, previously known as the National Association of Securities Dealers regulates securities firms and US exchange markets on behalf of the NYSE under the auspices of the Securities and Exchange Commission.

from 1975 to 1977 Russo was the deputy general counsel and the first director in the Division of Trading and Markets of the CFTC. Russo's reputation in government circles also qualified him in 1987 to serve as an advisor to the Brady Commission. This career and extensive experience gave the firm access to an extensive network of regulators and insights into the regulatory process and more importantly the philosophies amongst regulators at the time. See section 8.2.5 for an explanation of the 'revolving door' concept (Equilar Atlas 2008).

5.2.7 Ian Lowitt – Chief Financial Officer

Figure 71 - Picture of Ian Lowitt



Source: (Carney & White 2010).

Ian Lowitt graduated from the University of Witwatersrand in Johannesburg, South Africa with a Bachelor of Science in Electrical Engineering and Masters of Science in Digital Electronics. He also gained a Bachelor of Arts in Philosophy, Politics and Economics and Masters of Science in Economics from the University of Oxford where he was a Rhodes Scholar. Lowitt moved to LB from McKinsey and Co. in 1983 as Head of Corporate Development and from 2000 to 2008 had progressed through several senior management positions. He held roles such as: Treasurer and Global Head of Tax; Executive Vice President for Lehman Brothers Europe; Co-Chief Administrative Officer; and from June 2008 to the time of the bankruptcy, as the Chief Financial Officer. The role of Treasurer within any financial institution is a key position and important in the strategic and day to day funding activities of the firm. Therefore Lowitt would have had a deep insight of the firm's liquidity management in the period leading to the last days of the LB (Bloomberg 2015b; Carney & White 2010).

5.2.8 Michael Gelband - Global Head of Fixed Income

Figure 72 - Picture of Michael Gelband



Source: (The Real Deal 2015).

Michael Gelband graduated from the University of Georgia with a Bachelor of Business Administration and from the Ross School of Business at the University of Michigan with a Masters of Business Administration. He commenced with LB in 1983 and held several senior positions within the Fixed Income Division culminating in the role of Global Head Fixed Income Division from 2005 to 2007. Gelband was also appointed to the most senior executive committees of LB (McDonald & Robinson 2009). Gelband proved to be a skilled operator within the Trading Division and his relevance in this thesis evolves more from the circumstance of his departure than his appointment. Gelband was removed for his disagreements with Fuld on the excessive risk taking by the firm (McDonald & Robinson 2009). Gelband left LB in May 2007 and was eventually employed by Millennium Management, a New York based alternative investment manager (HedgeWeek 2008). Rather than publicly announcing Gelband's dismissal from LB, it was announced that he departed to pursue other interests (Mathiason et al. 2009). Gelband was of only a few subordinates willing to challenge Fuld in the strategic direction of the firm and on large transactions which although appeared profitable and prestigious at inception would have burdened LB with very high risks at a time when the property market was increasingly susceptible to a downfall. The following reveals this opinion was shared from within the firm:

The truth, though, was somewhat different. Gelband was, according to Lehman insiders, at loggerheads with Fuld's lieutenants. He had rallied against a huge buying of a collection of subprime mortgage lenders, and also in particular a USD 15bn property consortium bid, led by Lehman, to buy the US's biggest apartment company at the top of the market... According to Lehman insiders, he was almost alone among the 26,000-strong organisation in being prepared to stand up to the now disgraced former chairman and chief executive of what has become the world's biggest bankrupt company (Mathiason et al. 2009).

The above comments by Mathiason et al. (2009) is evidence of Fuld's objection to having close senior executives challenging his own personal decisions, especially if they involved barriers to the firm's growth strategy.

5.2.9 Herbert 'Bart' H. McDade III – Chief Operating Officer

Figure 73 - Picture of Herbert 'Bart' H. McDade III



Source: (Bloomberg 2015a)

Bart McDade joined LB in 1983 and similar to Fuld, Jack, Gregory and Gelband he started in the Fixed Income Division. He graduated with a Bachelor of Arts from Duke University and a Masters of Business Administration from the University of Michigan. In 1991 MacDade was appointed as Head of the Corporate Bond Department and in 1998 he progressed to the position of Global Head of Debt Capital Markets and concurrently named as a member of the Group Head Committee of the Investment Banking Division. In 2000 McDade was elevated to the key Executive Committee and at the same time assumed the role of Co-Head of the Fixed Income Division. From 2005, he headed the Global Equities Division and eventually replaced Gregory as COO shortly before the bankruptcy (Plumb & Wilchins 2008b). During his period in executive management, McDade's responsibilities encompassed the mortgage business which after recording huge losses was a major contributor to LB's collapse. McDade later joined Barclays for a brief period following the British banks acquisition of the US operations of LB after the bankruptcy (World Heritage Encyclopedia 2015).

5.2.10 Hugh E. ‘Skip’ McGee III - Head of Investment Banking

Figure 74 - Picture of Hugh E. ‘Skip’ McGee III



Source: (Levin 2015).

Hugh (Skip) McGee graduated from Princeton University with a Bachelor of Civil Engineering and achieved a Juris Doctor degree with honours from the University of Texas Law School. He was considered an intellectual and continued his association with the University sector as a Member of the Advisory Council of McCombs School of Business at the University of Texas and a member of the Advisory Council for the Bendheim Centre for Finance at Princeton University (Intrepid Financial Partners 2016). McGee joined LB in 1993, and became the Head of LB’s Global Natural Resources and Power Investment Banking Groups and a member of the Operating Committee of Investment Banking. He also became the executive in charge of the Global Investment Banking Division from 2002 until 2008 (Williams 2010). At the time of his promotion to Head of Global Investment Banking, he was the longest serving head of an Investment Banking Division in New York. During his time in the Investment Banking Division he presided over some significant transactions, including the largest leveraged buyout in history (former TXU Corp) and a USD 41 billion acquisition of XTO Energy by Exxon Mobil (Perlberg 2013). McGee also helped lead Lehman’s efforts to spin off toxic assets during the crisis.

McGee was an executive who was responsible for the substantial increase in LB’s risk profile in 2006 and 2007. According to Valukas (2010, pp. 58-9), “Along with Fuld and President Joe Gregory, and over the objections of other senior executives, McGee advocated that Lehman loosen controls and lend its own capital to private-equity companies for leveraged buyouts”. Despite his apparently impeccable reputation within the investment banking community in his early career, in later life McGee’s ethics were questioned. Following his career at LB, and during his role as head of the US operations of Barclays, he was involved in a large fraud. McGee oversaw a trading operation which was found guilty of manipulating energy markets for profit. The Federal Energy Regulatory Commission commanded Barclays, including four of its former traders to pay a total of USD 488 million in penalties (Abelson 2013). The review of the incident conducted by Rothschild Vice Chairman Anthony Salz, stated that the

“investment banker McGee helped lead a source of entitlement and ethical ambiguity... A few investment bankers seemed to lose a sense of proportion” (Abelson 2013). Steep bonuses and pay for top executives were considered a root cause of the fraud. It “contributed significantly to a sense among a few that they were somehow unaffected by the ordinary rules” (Abelson 2013).

5.2.11 Summary and Discussion

This chapter outlines a history of LB highlighting events and personalities that contributed to the development of the three overriding themes of this study: reliance on key relationships with government authorities and officials; influence through official, personal and commercial networks; and personal characteristics of key individuals and culture of the firm. The chapter was divided between the pre-Fuld and post-Fuld era to delineate the influences of past leaders. As Fuld was the CEO immediately preceding the bankruptcy, a focus on his stewardship is considered of greater importance to this thesis. Fuld had characterised his leadership by appointing to crucial positions like-minded, compliant staff who shared his values. These appointments almost exclusively originated from the trading side of the business, an area in which Fuld devoted much of his career and where he understood the trader transaction oriented mentality. Of the eight executives described above, six originated in the Trading Division, the exceptions being Russo whose position required a specific legal background and McGee who as Head of Investment Banking was appropriately sourced from that side of the business and was the only representative from the Investment Banking Division, the only other major division in the group at that time. Moreover these appointments reflected an inner circle with whom Fuld could feel comfortable and avert conflict.

In Pettit he found his original second in command, a loyal follower who eventually contravened Fuld’s own personal values and was therefore cast adrift. In Gregory, he found a sycophant, who overtly confessed that he had no aspirations for the leadership role and therefore became a safe ally in Fuld’s quest to survive his leadership position. In Jack he found a fellow fixed income trader with similar ideals, motivations and practices, especially a motivation for self-enrichment. In Lowitt he found a malleable and skilled operator who could transform from the central function of a Treasurer which required a trader’s skill base, to a Chief Financial Officer. In this latter role, Lowitt was responsible for the accounting and finance function, a crucial role in the preparation and presentation of financial information to the wider investment community and establishing positive perceptions necessary to ensure continued funding. In Russo he found a skilled regulator who had access to useful connections within the regulatory and legal spheres and who would be found to conform to the firm’s ideological interpretations of regulations and accounting practices. In Gelband, McDade and McGee he found intellectuals highly skilled in their field, who were driven to

succeed and could be relied upon to maximise the firm's profits. In summary each appointee was useful to Fuld's ambitions and stated objectives of 'growth at all costs'.

The cohort of senior management afforded the CEO the power to pursue his personal agenda. This power can be located in Clegg's (1989) dispositional circuit where, as the most senior executive in the group, Fuld had the power to promote or dismiss any executive. Through Fuld's dominant position in the hierarchy, he was able to influence his personal relations with each individual and his social relations with them as a group representing the passage point to the episodic circuit where these subordinates would carry out the firm's tactical decisions. Each executive therefore represented an agency through which Fuld was able to carry out his strategic objectives. They were provided with the resources and motivation to generate the outcomes that Fuld desired. Any resistance was addressed by Fuld in one of three ways: a reprimand, usually involving aggressive behaviour by Fuld; a sidelining of the executive to an innocuous position; or in the worst case, dismissal.

Fuld was able to legitimise his power through the firm's rules of practice also found in Clegg's (1989) dispositional circuit and which included amongst others, the group accounting policy manual, personal compensation practices, internal reporting framework and the firm's risk management policy documents. These documents regulated work practices and guided behaviour within the firm. Breaking the rules incurred consequences. Apart from the rules of practice contained in formal internal documentation, Fuld had allowed a cultural and moral organisational culture to evolve in accordance with his own values driven by an insatiable desire for growth, even if that meant elevating the risk profile of the firm. The written and unwritten rules of practice were integrated within the firm through individual and social relations established by Fuld and his executives. These rules of practice, which filtered down throughout the organisational hierarchy, fixed relationships of meaning and membership amongst staff. A principal outcome of which was the loyalty Fuld generated amongst a large majority of his team. This enabled Fuld to prolong his grip on power and his claim to being the longest serving CEO in LB's history since Bobbie Lehman's reign.

The power located in the episodic and dispositional circuits was enabled at the macro level through the facilitative circuit where the firm's system of reward and punishment was formulated. Although the actions of reward and punishment occur in the episodic circuit through the day to day dealings between superiors and their subordinates, the expectations of what is acceptable behaviour is established in the facilitative circuit. These norms are built up over time in the context of social and cultural change and innovation which can transform the structuring of empowerment and disempowerment. The use of job design, which involved the procedures relating to the dealing and recording of transactions, is a worthwhile example. The accounting for Repo transactions (further explained in CHAPTER 9) to increase the firm's funding whilst concealing it from external stakeholders, is useful in

applying power through internal relationships and with stakeholders alike. The act of concealment, that is, controlling an information flow, is an application of power. This level of power within the facilitative circuit contributed to affecting the organisational morality to a point where it differed with the moral standards of society at large.

This chapter contributed to an understanding of the organisational culture of LB through an analysis of certain periods throughout its history and an analysis of the behavioural characteristics of key personalities within LB. At various points in its history, power was exercised within the firm to generate outcomes beneficial to the CEO and at times arguably to the detriment of the firm – especially in terms of risk. The foundations of LB's business model and organisational culture were clearly established in the pre-Fuld era. In this era of LB's history, the founders' influence relating to innovation, business expansion, and effective use of networks and knowledge were combined with a focus on pursuing business activities consistent with the competitive strengths of the firm. A high degree of control exerted over subordinates and decision-making by the firm's leadership was integral to achieving the objectives of the managing partner or CEO. For example the elevation to partnership of only Lehman family direct descendants ensured tight control over the firm's strategic direction. As explained in this chapter, this control was effected through Clegg's (1989) various circuits of power.

In the post-Fuld era the inherited organisational culture emphasised the employment of individuals with sympathetic goals to those of the CEO. Key individuals were also required to have an attitude to risk taking arguably at the upper boundaries of the norms within the industry. Behaviour inconsistent with the values of the CEO was not tolerated and the exercise of power to shape the moral values within the firm was not withheld. In the following chapter, the thesis reveals the consequences of the power exercised by Fuld and his executives in the period prior to the bankruptcy. The behaviour of executives within LB during this brief but critical period was influenced by the already established organisational culture. It was also impacted by institutional influences within the investment banking industry and the benevolence of regulators. Refer to CHAPTER 7 and CHAPTER 8 for a discussion on the impact of institutional influence on LB.

CHAPTER 6 THE LAST DAYS OF LB

6.1 Introduction

This chapter chronologically examines the last days, weeks and months prior to LB's collapse. In following the chronology, key events and developments are identified which precipitated the failures of a number of financial institutions including that of LB. The analysis of the events reveals a repeated exercise of power and the effect of institutional influence on the activities of LB, the industry and regulatory and government attitudes. This thesis argues that dysfunctional behavioural and cultural influences on LB had established the foundation for a series of decisions which led to a deterioration of LB's risk profile which ultimately caused its bankruptcy. The chapter goes further to analyse the interactions involving power between Fuld, LB's employees and external parties and the institutional pressures which steered the company towards failure.

Section 6.2 examines the role played by innovation including the use of Collateral Debt Obligations and their eventual credit downgrading. An explanation is provided of LB's practice of warehousing mortgage related assets and the ultimate difficulty the company experienced in securitising these assets as a way of recycling the firm's balance sheet. This led to an overexposure to illiquid mortgage assets and CDOs which had been downgraded by the credit rating agencies. The effect on LB's share price especially through the shorting of LB's shares is discussed once the investment community discovered that LB was left with a large portfolio of sub-standard assets. The shorting of LB shares is offered as evidence of mimetic pressure operating within the investment banking industry. The section concludes with an explanation of how Fuld's resistance to a series of warnings relating to the firm's declining asset values is an exercise of power. Section 6.3 exposes the discovery by analysts - during a pivotal telephone conference, of a lack of sufficient transparency considered important to maintain investor confidence. The section follows with an analysis of Fuld's approach to dealing with market disquiet which involved succumbing to a flawed strategy spurred by mimetic pressure from within the industry. Fuld's denial of his own accountability is reflected by his response in using loyal staff members as scapegoats. This section also reveals the problems experienced by Bear Stearns and Fuld's reluctance to learn from its mistakes. Two key events immediately preceding LB's bankruptcy are covered in Sections 6.4 and 6.5. Firstly the government rescue of the large and important mortgage institutions, Fannie Mae and Freddie Mac; and secondly the detailed sequence of LB's last weekend. A contrast is made between the regulatory and political attitudes to the mortgage institutions, as well as Bear Stearns, and the attitude adopted towards LB's financial difficulties, which aids understand-

ing why LB was allowed to fail whilst others were rescued. Section 6.6 includes a discussion of how LB's failure culminated from a combination of exogenous environmental and endogenous factors which disempowered Fuld and his team and produced an institutional shift by the government and regulators towards an increasingly interventionist approach. Finally section 6.7 of the chapter summarises the effect that LB's bankruptcy had on financial markets and the government's attempts to stabilise them.

It is difficult to pinpoint the commencement of the last days of LB as any date chosen would be arbitrary. A case could be made to plot the start of the firm's demise during the period spanning the usurping of leadership by Glucksman from Petersen. The subsequent events leading to the sale of the firm to American Express highlighted the dysfunctional internal divisions between the 'traders' and the 'investment bankers' and signalled the emergence of the trader mentality into the strategic decision-making of the firm. Alternatively, the last days could be sign-posted by the American Express group spin-off of the firm, amassing it with liabilities. This was a time when Fuld's overriding influence as the 'new' firm's leader effectively commenced. For the sake of continuity in this thesis, an arbitrary timeline has been selected which portends that the last days of LB began during the latter part of 2006 when the number of rating downgrades issued by the major rating agencies such as Standard & Poors, Moodys and Fitch for CDOs peaked.

6.2 Innovation and its Pitfalls

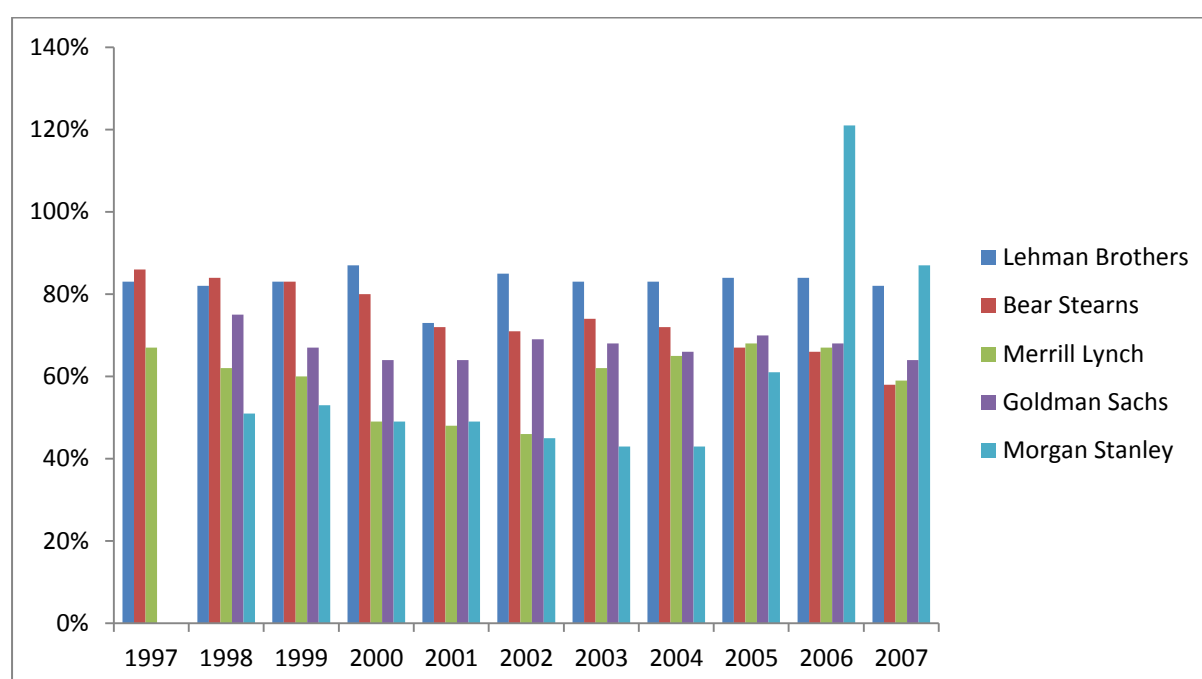
6.2.1 The CDO Rating Route

CDOs had become a popular financial instrument in the 2000s as they enabled investors to access a complex financial product which was backed by home mortgages. Previously access to these products was prohibitive to most investors or was gained through other securitised

financial structures such as RMBS or Mortgage Backed Securities (MBS)⁴⁹ (Fabozzi et al. 2006).

The combination of an exponential growth of the CDO market, (refer to the graph in Figure 78) in the two years prior to the collapse of LB, the sudden credit downgrading by the CRAs of most of these instruments and the deterioration of the quality of the subprime mortgage portfolios in general signalled the first publicly visible indications that LB was in trouble. LB had amassed a large quantity of CDOs and residential mortgages ready for packaging during this time and had therefore developed an overweight asset exposure to this market as shown in Figure 75.

Figure 75 - Warehoused Mortgage Assets and Other Investments as % of Total Assets



⁴⁹ A MBS is a security issued through a securitization process by a special purpose vehicle established to hold a pool of mortgages which are either originated by a related sponsoring financial institutions or purchased from another financial institution. The assets in the pool can consist of residential mortgages in which case the term used is Residential Mortgage Backed Securities (RMBS) or mortgages over other assets in which case the term commonly used is MBS.

Source: The data used for the graph was extracted from Orisis corporate database (Osiris 2014).

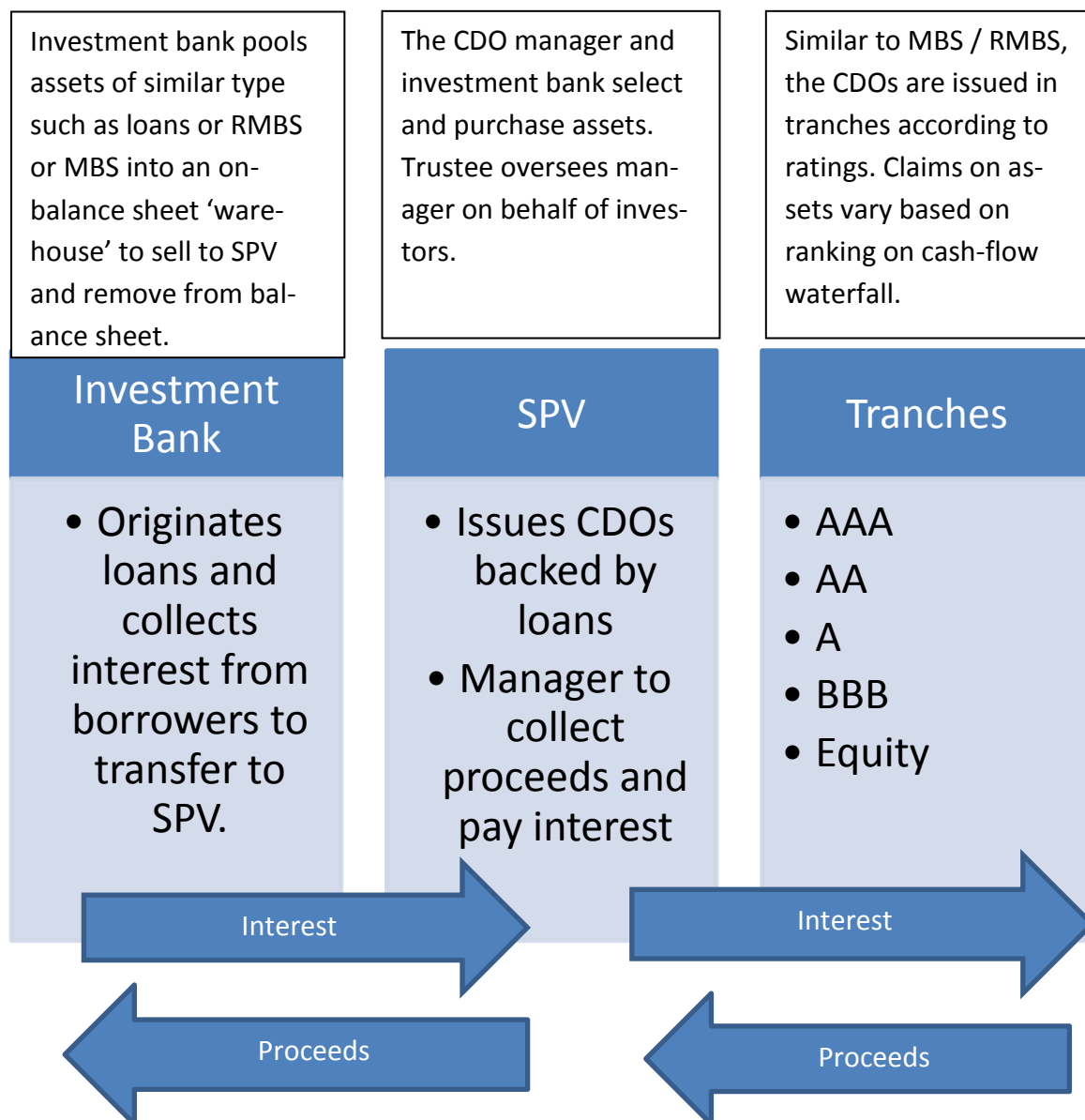
Once the credit ratings of CDOs were downgraded, existing and potential investors and creditors possessed explicit information signalling the likely negative impact on LB's financial position of its overweight position in these assets. These external stakeholders began to anticipate write downs on the value of the firm's CDOs and residential mortgage portfolio as explained later in this chapter. Consequently a negative sentiment of the firm's risk profile developed as indicated by the firm's declining share price (Figure 83). This development also impacted on other investment banks and most notably Bear Stearns which had a level of CDOs and subprime mortgage inventories similar to that of LB (Figure 75). Other hedge funds and commercial banks which were heavily exposed to these financial instruments were not immune to the market reaction. An atmosphere of nervousness and uncertainty permeated the market, which was starved for detailed financial information regarding the value of portfolios invested in credit derivatives and residential mortgages generally.

6.2.2 Warehousing and the Process of Securitisation

Warehousing involves the accumulation of securities or financial products such as residential mortgages by an originator into either the balance sheet of the originator, or a special purpose vehicle (Australian Securitisation Forum 2018). Where the originator is a bank or other financial institution that must meet capital adequacy requirements, the arrangement usually involves a complex structure whereby the pooled assets are sold to a 'special purpose vehicle' (SPV). The SPV then issues securities to investors, the proceeds of which fund the SPV's purchase of the pooled assets. Once the assets are transferred to the SPV, there is normally no recourse to the originator. In order to achieve this, the governing document of the issuer (SPV) restricts its activities to only those necessary to complete the issuing of securities (Australian Securitisation Forum 2018).

The entity (either a SPV or financial institution) in which the pooled assets are being held during the accumulation process, is referred to as 'a warehouse'. The securitisation process extracts these assets from the warehouse to on-sell them to investors in the form of new securities often categorised into tranches according to their credit ratings. Refer to Figure 76 for a diagrammatical representation of this process as it is applied to CDOs.

Figure 76 - Typical CDO Structure



Source: Diagram developed from Financial Crisis Enquiry Commission (2011, p. 128).

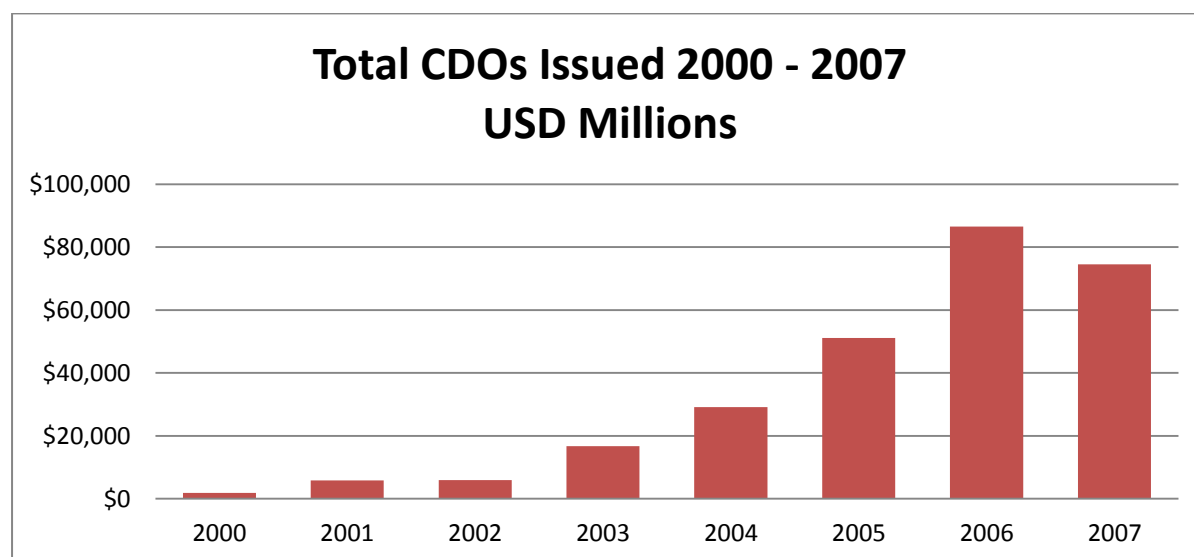
CDOs first appeared in the 1980s, however it wasn't until the 1990s when volumes of issues began to rise (Fabozzi et al. 2006). Figure 78 illustrates the growth in CDOs issued from 2000 to 2007. As the graph indicates, CDO issues grew exponentially until 2006 and levelled off in 2007 which coincided with the tightening of credit conditions, known as the global credit crisis (Fabozzi et al. 2006). This growth paralleled the significant growth in structured finance and credit derivative transactions generally during this period. Refer to Figure 77 and Figure 78 for the evolution of the of structured finance market in the period leading to the GFC.

Figure 77 - Total Number of Structured Finance Tranches Issued

	1983	1990	2000	2006
Number of Tranches	29	1,581	9,353	47,055
USD	na	na	1,839	86,572

Source: (Benmelech & Dlugosz 2010, pp. 166-8).

Figure 78 - Total CDOs Issued 2000 - 2007



Source: The data used for the graph was extracted from SIFMA Global CDO Issuance Tables, (Securities Industry and Financial Markets Association 2013).

The credit rating agencies assigned the highest rating of 'AAA' to the majority of CDOs outstanding globally in 2006 but by 2007 30% of the 'AAA' tranches had been downgraded (Benmelech & Dlugosz 2010, p. 161). The number of downgrades accelerated between 1999

and 2007, reflecting the deteriorating credit profile of the CDO market during this period. During the four year period between 1999 and 2002 inclusive, CDO downgrades by all major ratings agencies totalled 3,116. During the four year period between 2003 and 2006 inclusive, it amounted to 6,173 downgrades and in the year of 2007 alone, downgrades totalled 8,109 (Benmelech & Dlugosz 2010, p. 161). Many downgrades occurred from AAA to BB or lower (considered junk bond⁵⁰ quality) (McDonald & Robinson 2009, p. 200). Such sudden and steep downgrades were considered rare and therefore caught much of the market by surprise.

The downgrades were driven by an increasing default rate prevailing on home mortgages, which were the major asset class underlying the CDO instruments. Many of these CDOs had packaged subprime mortgages as their underlying asset and most of these mortgages were structured with adjustable rate mortgages (ARMs) (Fabozzi et al. 2006). Given these mortgages mainly originated within the previous two years, their interest rates were in the process of being reset above the original discounted 'honeymoon' rate⁵¹. Consequently homeowners were experiencing increasing difficulty in servicing their repayments because of higher interest reset rates which reached a peak of 27% in December 2006 (McDonald & Robinson 2009, p. 201). These difficulties translated into higher loan delinquency levels. There were other reasons for the downgrades which are addressed by Ashcraft (2009) who contends that the ratings models used to assign the original ratings were flawed. He also argues that the CRAs were under pressure by the investment banks to increase the number of ratings for new issues which promoted munificence amongst rating staff. This issue was compounded by the deteriorating credit quality of the underlying assets. "CDO structures were willing to accept loans that traditional investors would not have accepted, and originators began originating riskier and riskier loans" (Ashcraft 2009, p. 638).

⁵⁰ A junk bond is a colloquial term for a high-yield or non-investment grade bond with a relatively high default risk relative to investment grade bonds. Junk bonds are fixed-income instruments that are assigned a 'BB' rating or lower by Standard & Poor's, or 'Ba' or below by Moody's.

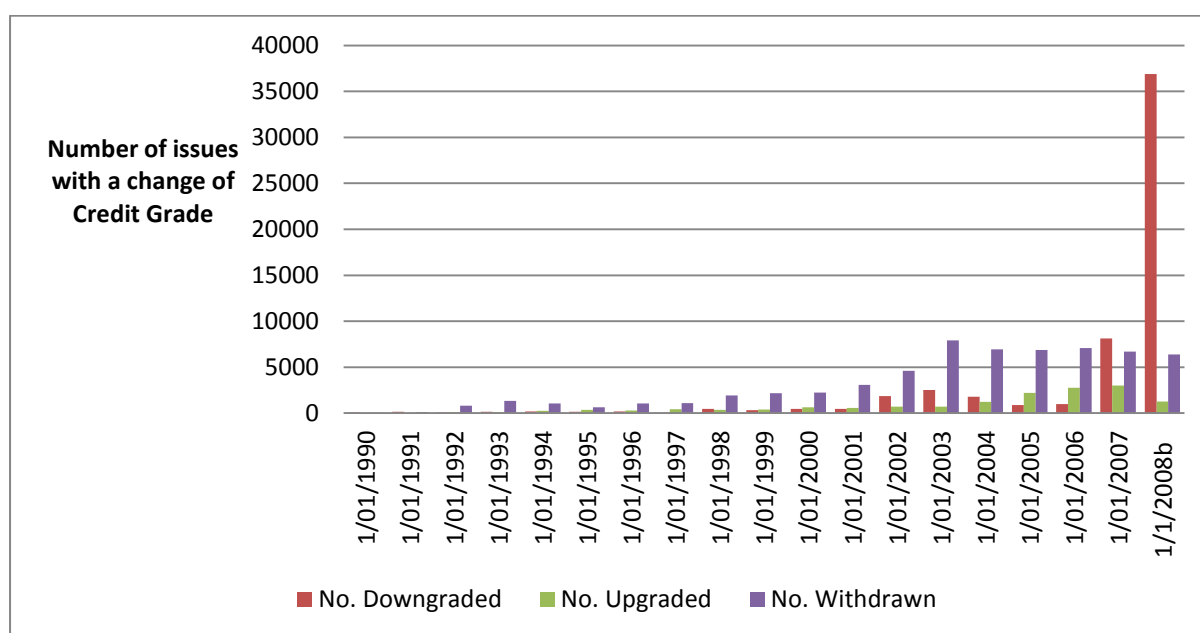
⁵¹ 'Honeymoon' rates were introductory interest rates offered by banks as a marketing ploy to induce borrowers to enter into loan contracts. In most cases the introductory rate was at a discount to normal market rates for the first six to twelve months of the loan. At the expiry of this period, the loan would revert to the standard variable rate.

The problem was compounded by the outsourcing of the origination process to commission agents who had little concern for the credit quality of the loans being accumulated. As they were not employed by the investment banks, their accountability for the credit quality was negligible and they were largely driven by the amount of commission they earned which was based on volume of loans written. Further the responsible executives within LB had a relatively low concern for the credit quality of the loan portfolios as their intention was to speedily securitise the assets and transfer the associated risk to the ultimate security holders. Whilst the securitisation process proceeded quickly, and the housing market remained buoyant, the on-balance sheet credit risk to LB was considered low.

LB was a major instigator in the origination and selling of CDOs and mortgage related structured assets generally. On November 30, 2006 LB had approximately USD 57.73 billion in mortgage-related assets, equivalent to 300% of the firm's total equity. Of the USD 57.73 billion in mortgage-related assets, USD 15.93 billion was subprime quality and mostly represented the remaining unsold portions of issues arranged by LB. In other words, by the end of 2006 LB had 83% of its equity tied up in extremely risky mortgage-related assets (Deng et al. 2009). During 2007, LB's mortgage-related assets jumped from USD 57.73 billion to USD 89.11 billion, representing 25.5% and 28.5% of total financial instruments owned in 2006 and 2007 respectively. Of the USD 89.11 billion mortgage-related assets in 2007, approximately 46.5% had been repackaged into complex asset-backed securities. As of 30 November 2007 LB had USD 17.31 billion in either subprime holdings or retained interest in securitisations, and only USD 22.49 billion in total equity (Deng et al. 2009).

Figure 79 shows all outstanding CDO tranches as at 1 January for years 1990 to 2008 which were downgraded, upgraded or withdrawn. It is important to note that Figure 79 provides information for all outstanding tranches and not solely new issues for the year. In 2007, although CDOs outstanding grew by 31.7%, the number of downgrades increased by approximately 800%, indicating a serious credit problem associated with the underlying assets of the structures of CDOs. This trend continued into 2008 when "there were 36,880 downgrades of structured finance tranches in the first three quarters of 2008, overshadowing the cumulative total number of downgrades in 2005/07 ... Downgrades were not only more common but also more severe in 2007 and 2008" (Benmelech & Dlugosz 2009, p. 172).

Figure 79 - Credit Rating Downgrades, Upgrades and Withdrawn



Note: b = Rating actions between 01/01/2008 and 22/09/2008.

Source: The data used for the graph was extracted from Benmelech and Dlugosz (2010, p. 181).

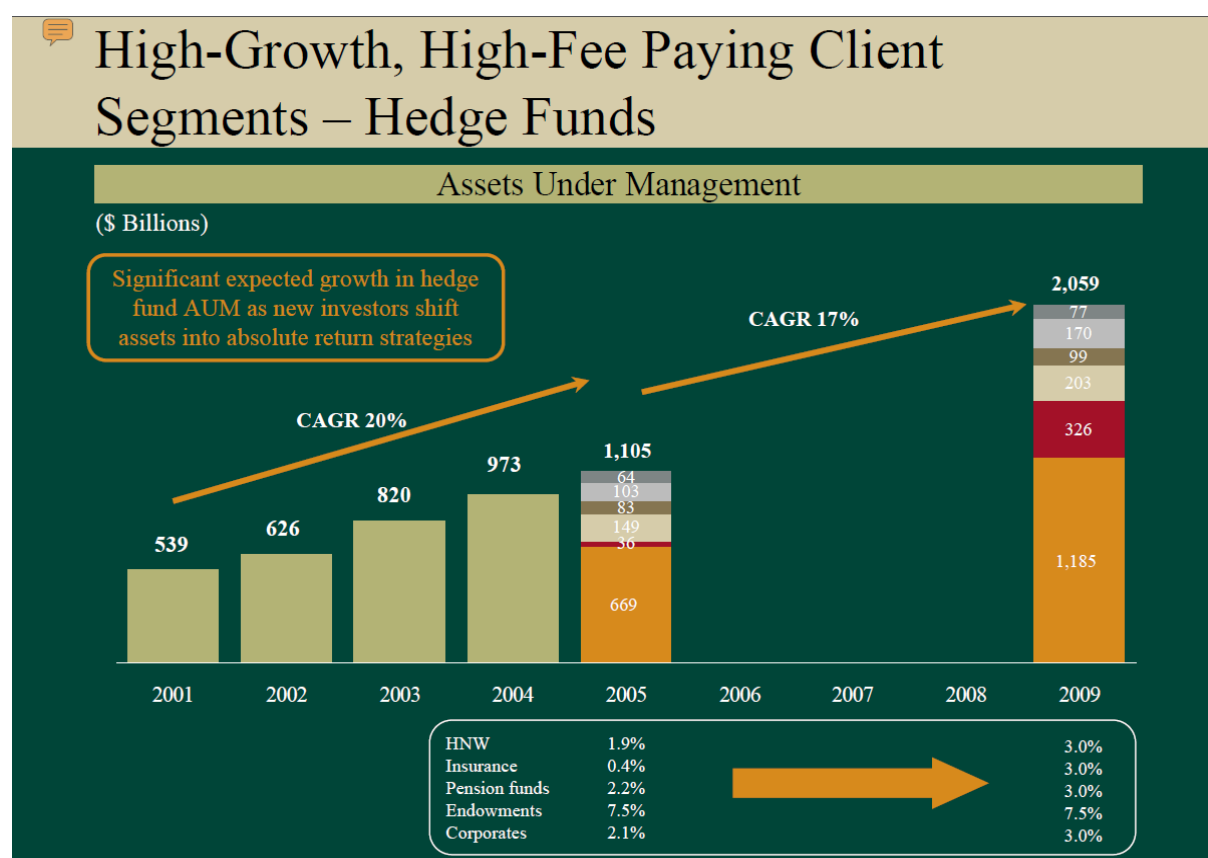
LB's large mortgage holdings, especially subprime mortgage holdings and investments in the equity tranches of asset-backed securities caused major financial difficulties for LB. In the fourth quarter of 2007, LB recorded a USD 3.5 billion write-down in mortgage assets, followed by another USD 4.7 billion mark-to-market loss in the first quarter of 2008. This revelation of the deteriorating quality of LB's portfolios of CDOs precipitated a decline in LB's share price. See Figure 83 for a chart of LB's share price.

A disturbing feature of this period is that LB had been made aware of the deteriorating quality of the CDO portfolios by internal and external sources. Despite these warnings, LB continued to issue new tranches of similarly structured CDOs. McDonald and Robinson (2009, p. 201) acknowledge that Alex Kirk, then Global Head of Credit at LB, had predicted the problems associated with LB's portfolios. "[Kirk]...was the first to flag it, in May 2005 - one year and seven months before it started to fall apart". Alex Kirk was well qualified to comment, having held positions within LB of Global Head of Principal Investments, Global Head of Credit from 2006 to 2008, Chairman of the High Yield Committee from 2002 to 2005 and head of the Global Distressed Division from 1994-2001. Kirk had advised Fuld of the impending problems. Gelband also warned Fuld of the impending deterioration of the portfolio held by LB:

Mike Gelband (who at the time had responsibility for commercial and residential real estate), yelled it publicly, with facts and figures, for everyone to hear, from Fuld downward at 7.06am on June 7 2005 - one year, six months, and three weeks before... many at Lehman Brothers had heard the warnings, and all through those months heard the rumours (McDonald & Robinson 2009, p. 202).

Lawrence Lindsay, an external consultant to LB, as president of The Lindsay Group, and a former director of President George Bush's National Economic Council also made presentations to LB's executive committee about the home lending market. He warned LB about the problems faced by borrowers as their interest rate resets were applied and about the potential negative impact these would have on the banks' distressed debt levels (Becker et al. 2008; McDonald & Robinson 2009). These warnings were ignored by Fuld and ran contrary to his stated ambition to invest further into hedge funds (holding subprime residential mortgages and CDOs) in order to increase profitability and hence the share price. Refer to Figure 80 which is a slide in a Global Strategy Offsite Presentation setting out the firm's strategy to grow hedge funds at a compound annual growth rate of 17% between 2005 and 2009.

Figure 80 - Lehman Brothers Global Strategy Offsite Presentation – March 2006



Source: (Lehman Brothers Holdings 2006, p. 28).

Fuld was pre-occupied with LB's share price, making it the focus of the firm's strategy as depicted in the same presentation. Refer to Figure 81 for the presentation introduction which featured the overriding strategy of reaching a share price of USD 150. At that time the average share price for March 2006 was USD 144, having increased from USD 128 on 1 January 2006 and USD 87 on 1 January 2005. Fuld also intended Lehman to rank first or second in targeted business segments. As the bulk of Fuld's compensation was awarded as LB stock he had a personal interest in maximising the firm's share price. See section 10.5 for a detailed discussion of the methods used and amounts comprising the top executives' compensation for 2007.

Figure 81 - Introduction of Lehman Brothers Global Strategy Offsite Presentation, 2006



Source: (Lehman Brothers Holdings 2006, p. 2)

Consequently LB continued to grow its exposure to the CDO and subprime mortgage market. Once these instruments were ultimately revalued by LB, for financial reporting purposes, the write downs had to be brought to account. Refer to Figure 82 for the latest announced write downs for LB during 2008. The ABS CDOs and RMBS write downs represented the majority of the firm's total write downs of USD 9 billion.

Figure 82 - Structured Asset Write downs for LB - 2008.

Write-Down	2007/ 2008	ABS CDOs	Corporate Credit	RMBS	Other	Total
LB's Write downs (USDm)	Note (a)	200	1,300	4,100	3,400	9,000
% of Total Industry Write downs	Note (b)	0.09%	2.45%	4.83%	2.07%	1.73%
Total Industry Write downs (USDm)	Note (b)	218,215	53,325	84,809	163,735	520,084

Sources:

- a) LB's Quarterly Reports for quarters 1, 2 and 3, 2008, (Lehman Brothers Holdings 2008b, 2008c, 2008d)
- b) Relates to write downs for 2007 (Benmelech & Dlugosz 2009, p. 163)

Exercise of Power in Resisting Warnings

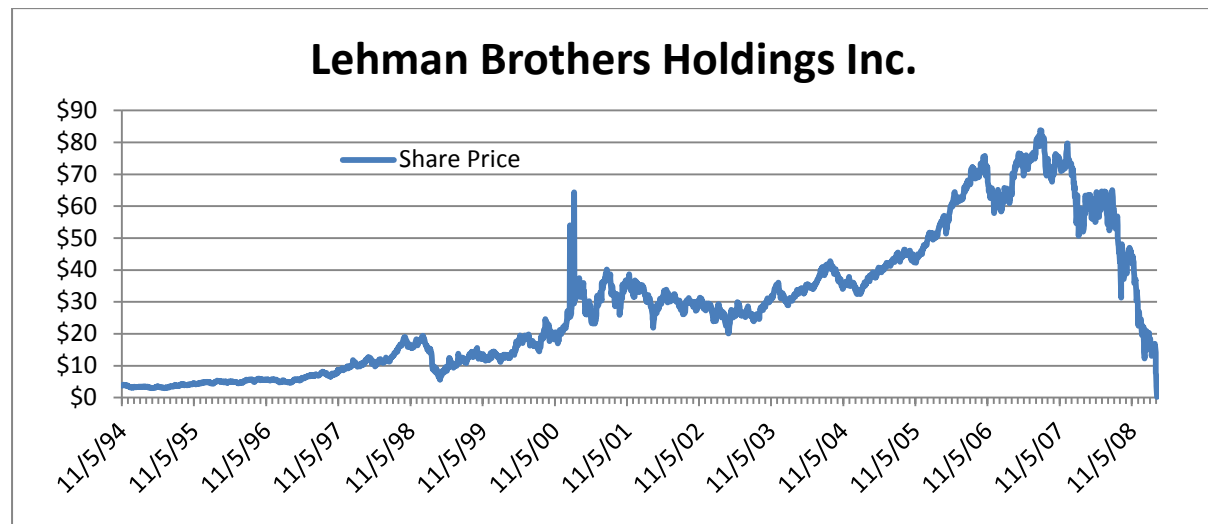
The process of communicating concerns to Fuld was undertaken in the normal course of day to day business activities. The experts, Kirk and Gelband viewed it as their duty to warn Fuld of the impending dangers to LB of developments in the subprime mortgage market and the associated exposures held by LB. The warnings also came from outside sources such as Lindsay and therefore were independently validated (McDonald & Robinson 2009, pp. 200-24). Fuld's resistance to this advice is an example of Fuld's assuredness of the superiority of his knowledge regarding the market environment. This perceived knowledge situates Fuld, a CEO with a long history in the financial markets, in a position of influence over the wider firm's employees – in particular those without an expertise in the field of knowledge claimed by Fuld. This confers power to Fuld over subordinates in the firm within Clegg's episodic circuit and allowed him to pursue a strategy consistent with his own views of the market. This power which is often exercised intermittently, involves power over another, in this case LB's employees. Power in the episodic circuit usually "calls forth resistance because of the power/knowledge nature of agency" (Clegg 1989, p. 208). The resistance offered by Kirk and Gelband was overcome by Fuld's authority as CEO. This position of authority continued as long as Fuld's perceived superior knowledge was able to convince the wider firm and attract the continued support of the Board of Directors who ultimately dictated whether Fuld continued in his role as CEO. "Kirk, Gelband and Lindsay had sounded warnings...and you can never fix stupid" (McDonald & Robinson 2009, p. 202).

6.2.3 Effect on share price

Figure 83 plots LB's split-adjusted share price from 1994 when the firm was spun off by American Express to September 15, 2008, the day of its bankruptcy. LB's share price decline,

from USD 78.12 on December 29, 2006 to USD 19.12 on June 30, 2008 and to USD 3.65 on 12 September 2008 (the last trading day before the bankruptcy announcement) reflected an increasingly pessimistic assessment of LB's viability. This period also reflects the steepest decline in LB's share price history.

Figure 83 - Lehman Brothers Holdings Inc. Adjusted Closing Share Price*, 1994 – 2008



Note: The share price indicated above is quoted as an adjusted share price, reflecting the stock split which occurred in April 2006.

Source: Data for graph obtained from share price database, (Investorpoint Investor Information Systems 2016).

Selling and Shorting LB shares as Mimetic Isomorphism

In CHAPTER 2, two accounts were postulated as explanations for a financial crisis, exogenous and endogenous approaches. The exogenous approach supports the assumption that information sourced from outside the market is absorbed by the market, and trading based on this information is reflected in the price of a security. Alternatively, under the endogenous approach, the price of a security is influenced by the behaviour of other traders in the market. This emphasises that social interaction within markets can precipitate a crisis. Therefore, the markets are subject to the 'herd mentality'.

Dyer et al. (2008) discovered in scientific experiments that it takes a minority of just five per cent of a group to influence a crowd's direction and that the other 95 per cent follow without realising it. That is, where information is ambiguous, individuals are prone to making decisions based upon the actions of others. Swedberg (2010, p. 71) finds that "confidence plays a key role in financial panics and that confidence can be conceptualised as a belief that action can be based on proxy signs, rather than on direct information about the situation itself". While some proxy signs are official, others are unofficial, such as articles in the busi-

ness press about a firm, or gossip from an acquaintance. Unobtrusive proxy signs belong to the category of unofficial signs and are often viewed as valuable, because they are thought to be difficult to manipulate (Swedberg 2010). This, of course, is also what makes them so attractive to manipulate.

According to Labaree (1961), Benjamin Franklin, in a *Letter to a Young Salesman*, 21 July 1748, gives the new owner of a carpentry business the following advice: “The sound of your hammer at five in the morning, or eight at night, heard by a creditor, makes him easy six months longer” (Labaree 1961). The proxy sign in LB’s instance, unlike the sound of the hammer, was a negative sign and included the rumours and press speculation that spread throughout the market. The rumours and actions of other traders in shorting LB’s stock perpetuated an already declining share value, almost self-fulfilling an eventual demise of the firm. Platt (2002, p. 8) observed “quite a substantial amount of short selling activity takes place when companies face bankruptcy...Shorting the stock of a distressed company puts extra financial pressure on it by devaluing its equity and pushes it to the verge of a fall”.

The activity of the market participants in selling LB shares was driven from limited information such as the credit rating downgrades, press reports and rumours. These relatively uninformed trades (uninformed at the time of trading) support the endogenous approach to understanding markets, which is consistent with an institutional view. It provides a rationale for selling a stock in the absence of explicit detailed financial information. When other traders are executing similar trades, this is interpreted as legitimate for no other reason than there being safety in following the herd. This according to DiMaggio and Powell (1983) and Schacter et al. (2011), is a form of mimetic pressure. The mimicking of trades gives comfort to traders, supporting their own decision-making as being consistent with others in the market.

6.3 Importance of Transparency

6.3.1 Telephone Conference of 14 March 2007

On 14 March 2007, in response to a demand for information by analysts on progress with the first quarter’s results, LB organised a conference call for interested institutional investors and securities analysts. The LB representative on the call was the Chief Financial Officer, Chris O’Meara. It was clear from O’Meara’s initial presentation that his objective was to obfuscate the details of LB’s exposure to the subprime market. O’Meara briefly passed over LB’s holdings of subprime mortgage securitisations by mentioning they only comprised less than 3% of LB’s total revenues (McDonald & Robinson 2009, p. 221). This response is more revealing as to what it doesn’t disclose as to what it does. O’Meara conveniently omitted

any analysis of the relevant exposure as a percentage of equity or assets, which would have represented a more meaningful ratio relevant to the assessment of LB's financial position.

An excerpt of this conference call between Michael Mayo, an analyst from the Prudential Equity Group and O'Meara follows:

Michael Mayo - Prudential Equity Group

Then, a separate question; subprime revenues are under 3% with your characterization, but if we are not talking about a housing crash or a recession but still a possible domino effect from subprime to other areas, what other exposure do you have to the subprime mortgage market?

Christopher M. O' Meara - CFO Lehman Brothers

To the subprime mortgage? Okay, so there are situations -- are you talking about warehouse lending or --

Michael Mayo - Prudential Equity Group

More generally, what is your total balance sheet exposure to subprime mortgage, either direct or indirect?

Christopher M. O' Meara

We have a fair amount of exposure. We talked about the residual interests which represent a levered exposure. We also have whole loans, but all of it is subject to the same hedging principals that we talked about earlier and it has been working quite effectively.

Michael Mayo - Prudential Equity Group

But when you said that the hedging offset the losses, the hedging offset the losses in which areas?

Christopher M. O' Meara

Essentially everything. Our objective is to try to offset the risks that sit in the business as we are moving these instruments and holding the instruments in what we will call our client warehouse as we are moving them from raw product into securitization, and then if we are making secondary markets and taking positions that we are distributing and sponsoring client activity, while that is in this warehouse and on the balance sheet, we are trying to hedge the components of risk that exist -- the interest rate risk, the pre-payment risk, the various risks that exist. We are actively, dynamically trying to risk mitigate. (Seeking Alpha 2007)

Exercise of Power in the Dispositional Circuit

The above exchange can be interpreted as a means of limiting information disclosure by O'Meara. The vague and convoluted responses supplied by O'Meara were clearly intended

to obscure the severity of the problems being faced by LB. This interaction between Mayo, a representative of a stakeholder group of investors and O'Meara, the representative of the firm and of Fuld, the Chairman and CEO, can be analysed by Clegg's (1989) dispositional circuit. In this circuit, the rules of practice are constituted by the typical verbal presentation followed by the question and answer pattern of communication between the listed entity (LB) and stakeholders. The call was the arena in which O'Meara decided to control the dissemination of vital information. If the information was not convincing, it could potentially have severe consequences on the firm's critical relationships and ultimately its share price.

O'Meara's evasiveness in the 'us and them' exchange was an attempt for O'Meara to influence Mayo and others listening to the call. The obligatory passage point in Clegg's (1989) framework is represented by the conference call, whereby the agency, in this case Mayo, contests O'Meara's responses, the tone of which is in turn refixed to disarm the agent. O'Meara had the benefit of a final response to each question and therefore had the ultimate ability to shape opinion. Further obfuscation was practiced in the release of LB's third quarter results as reported by the media (Ellis 2008; Hamilton 2007). O'Meara was defending the accuracy of the financial results and sought to allay concerns that investment banks might be moving too slowly to write off potentially large amounts of troubled mortgage securities. O'Meara was content that the firm had a robust accounting process to produce accurate and reasonable financial statements (Hamilton 2007). Securities analysts weren't convinced however and a securities analyst, Schiff commented:

In any case ... the future isn't bright for Wall Street banks... They're not going to be making all these profits in their hedge funds ... They're not going to be making all these [merger] deals and private equity deals. They're not going to get all those tremendous fees and commissions (Hamilton 2007).

It is clear that O'Meara's assertions to the firm's robust process in checking its accounting of the mortgage securities was meant to divert attention from the actual results and instead focus on process, that is to provide comfort to analysts that a conservative approach had been followed. Unfortunately for LB, Schiff and others were not convinced.

6.3.2 Fuld's Response to Market Disquiet

First Leg of Strategy - Expansion

In response to market rumours, which were particularly rampant following the March telephone conference call, Fuld pursued a new strategy of globalisation and undertook acquisitions of hedge funds internationally to convince the market that LB had other options to reverse its performance. "The foreign purchases were inspired by the avowed belief of Fuld...that globalisation meant decoupling from the US market because it was no longer all-powerful" (McDonald & Robinson 2009, p. 223). Since the late 1990s, LB had developed a

large mortgage origination business, supplemented by a meaningful securities issuance and distribution business and a strong underwriting business. The strategy had been to originate and distribute securities as it had done during Philip and Bobbie Lehman's reign. Following its March 2006, Global Strategy Offsite, Lehman Brothers Holdings (2006) announced that LB's strategy had evolved. Rather than originating mortgage assets for eventual packaging and disposal to investors, LB would retain those assets on its balance sheet. LB effectively shifted its strategy from focusing on securitisation to a business of accumulating assets (Financial Crisis Enquiry Commission 2011, p. 177). This aggressive growth strategy also involved greater leverage and risk. The combination of the warehousing strategy supported by greater leverage would come to punish LB when the values of the underlying assets being stored plummeted.

Shortly thereafter in 2007, LB acquired Europe's largest hedge fund, GLG Partners (London), based in London. By mid-year 2007 LB acquired 20% interest in New York-based D.E. Shaw, a global investment and technology development firm, and a further 20% of the USD 5 billion London based hedge fund Spinnaker Capital, specialists in emerging markets. As well as Spinnaker Capital, LB continued to expand in the UK and acquired a 5% stake in Blue Bay Asset Management which had assets under management of USD 8 billion. Later it acquired Grange Securities, one of the largest sellers of CDOs in Australia. These hedge funds were in addition to a previous acquisition of a major US commodity hedge fund, Ospraie which managed about USD 2 billion of assets (McDonald & Robinson 2009).

Fuld was envious of the Blackstone Group, a private equity firm co-founded by Pete Petersen, following Petersen's exit from LB (McDonald & Robinson 2009; Reingold 2009). One of the main reasons for Fuld's envy was the fact that Peterson as one of two co-founders of Blackstone Group, benefited enormously from the 2007 initial public offering of Blackstone, valuing the firm at USD 4 billion. The listing enabled Blackstone to become one of the first major private equity firms to list shares in its management company on a public exchange (Anderson 2007). Fuld was aware that the Blackstone group completed a USD 39 billion buy-out of Equity Office Properties Trust earlier in 2007 and viewed this transaction as a justification of his hedge fund strategy (McDonald & Robinson 2009). Fuld however wasn't aware

that Blackstone's own strategy involved flipping⁵² the properties within the trust in the short term (Pristin 2008). LB instead was investing for the long term which represented quite a different strategy.

Mimetic Pressure a Solution to Financial Difficulties

Given Blackstone Group's strong reputation in the market, which was primarily due to the standing, character and experience of its co-founders, Fuld succumbed to a mimetic pressure of replicating a strategy undertaken by a competitor in order to achieve commensurate rewards. If the market was interpreting the Blackstone Group strategy as sound, then why wouldn't the market ascribe the same supposition to LB? Blackstone's practice as a hedge fund was to use high levels of leverage to make acquisitions of underperforming corporations or assets, turn around the performance, and dispose of the investment at a profit (Pristin 2008). Fuld's mistake was to ignore the short term nature of the Blackstone group strategy and instead according to Lehman Brothers Holdings (2006), pursued a flawed long term hold strategy. LB continued to compound its property exposure during June 2007.

It [LB] partnered with Thomas Partners, a real estate investment trust based in Los Angeles, and the California State Teachers Retirement System in a USD 1.15 billion deal to purchase 10 office buildings that Blackstone was selling from its Equity Office Properties acquisition (Pristin 2008).

In July 2007, just as the global credit crisis began, LB acquired, in partnership with Prologis, a publicly listed logistics company, which owned a group of warehouses located throughout the US for USD 1.85 billion. LB financed the bulk of the transaction on its own balance sheet in order to accelerate the closure of the transaction (Pristin 2008). Normally such a large funding requirement would have been syndicated amongst several banks. Not only was LB caught with the debt but was unable to securitise the asset (Pristin 2008). Consequently the asset and the corresponding debt remained on its balance sheet, further weakening the leverage of the firm.

⁵² Flipping is a term used primarily in the US to describe purchasing a revenue-generating asset and quickly reselling (or 'flipping') it for profit.

LB had a strong appetite for real estate investments, as Fuld believed the real estate asset bubble would continue indefinitely and in mid-June 2007 added high value commercial real estate assets from Texas to the portfolio. “One real estate investment broker described Lehman as the real estate ATM” (Pristin 2008). The expansion of the firm’s investment portfolio featured prominently in the firm’s strategy (Lehman Brothers Holdings 2006). Rubinstein (2008) notes that LB’s appetite for real estate assets encouraged the firm to use off balance sheet structures to house them and its comparative exposure to real estate outweighed those of its competitors. “You talk to Morgan Stanley, they have \$3 billion worth of [commercial mortgage-backed securities] exposure in the States. Lehman had \$30 billion” (Rubinstein 2008). Direct investments in real estate were supplemented by indirect exposures by way of extending loans against property mortgage security. LB’s search for opportunities in this sector was aggressive as it turned to riskier loans to fulfil its strategy. “The firm, according to one developer, became known as the lender of last resort on Wall Street, willing to loan money to just about anyone” (Rubinstein 2008).

The real estate binge continued in October 2007, when LB acquired a portfolio of almost 400 apartment buildings across the US in partnership with Tishman Speyer. LB invested equity of USD 250 million and led a syndicate of lenders, together with Fannie Mae and Freddie Mac, that contributed USD 4.6 billion in bridge equity for the USD 22.2 billion transaction (Pristin 2008). The deal represented the largest listed to private merger and acquisition transaction in the Real Estate Investment Trust (REIT)⁵³ sector (Pristin 2008; Trainor 2007). This transaction was completed shortly after Standard & Poors and Moodys issued warnings on a weakening rental market and deterioration in mortgage lending standards (Pristin 2008; Wilcox 2012). Fuld’s rejection of the credit rating agencies’ warning was another example of hubris and a determination to solve the firm’s problems by pursuing a flawed strategy of expanding through an asset class which was at the top of its price cycle.

⁵³ A tradeable security listed on the major exchanges and invests in real estate directly, either through properties or mortgages. REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate.

Fuld wasn't content with investing in hedge funds alone. Hubris led him to invest in other unrelated businesses through the firm's Private equity⁵⁴ Division. In August, LB was in negotiations to purchase 66% of Eagle Energy Partners, a Houston-based energy services corporation for USD 400 million; in addition LB was involved in multi-billion dollar commitments with TXU, Claire's Stores, First Data Corporation, Home Depot and International House of Pancakes. "Both men [Fuld and Gregory] were devotees, apparently of the very suspect maxim that it's always possible to spend your way out of trouble" (McDonald & Robinson 2009, p. 262).

Second leg of strategy – Share Repurchase

The second leg of LB's strategy was to repurchase its own shares to counteract the rumours of LB's potential on-balance sheet problems. In creating the appearance of a strong balance sheet which could withstand share repurchases and payment of high dividends, LB acquired USD 2.6 billion worth of its own shares and paid dividends of USD 418 million during the financial year ended 30 November 2007. The issuance of new shares during this period totalled a meagre USD 84 million (Lehman Brothers Holdings 2008j). By increasing the demand for LB shares on the market, Fuld was hoping the share price would increase. This caused much discord amongst senior executives including Gelband who on hearing of the repurchase exclaimed "Buying it? ... he should be fucking selling it to raise capital" (McDonald & Robinson 2009, p. 224).

The share repurchase strategy is an example of misplaced hubris and an abuse of power. The act of repurchasing shares with borrowed funds has a compounding effect on leverage. The leverage ratio which is a measure of risk of a firm may be calculated as a ratio of total debt to total stockholders' funds. A higher ratio indicates more risk. Buying back the number of shares outstanding reduces the balance sheet value of stockholders funds (on the basis that the same shares are subsequently cancelled). The combination of a reduction in stockholders funds whilst borrowing to effect the repurchase amplifies the increase of the ratio. See to section 7.3 for a financial analysis of LB and its increasing leverage ratio.

⁵⁴ In finance, private equity is an asset class consisting of equity securities and debt in operating companies that are not publicly traded on a stock exchange. A private equity investment will generally be made by a private equity firm, a venture capital firm or an angel investor.

Abuse of Power in the Facilitative Circuit

In extending leverage, Fuld elevated the risk profile of the firm. In the process he further jeopardised the survival of the firm and therefore the job security of its employees and safety of the financial claims of stakeholders such as stockholders and lenders. Fuld attempted to fix perspectives about the firm, despite overt objections from other senior executives who deemed the action of share repurchase irrational but nonetheless were powerless to change Fuld's actions.

The position of Chairman and CEO had the authority to fix the standards of 'leverage acceptability' within the firm in response to the prevailing exogenous environmental stimulus. This environment was characterised by the market rumours which prompted Fuld's action. The Chairman's authority was further strengthened as Fuld's decisions occurred during a time of crisis when decisive action is an accepted practice in corporate management as a means of appeasing stakeholders. Subordinates felt powerless to contest Fuld's authority through any communication or obligatory passage points available within the firm, such as the executive committee over which Fuld held a strong influence.

Ultimately the disagreement between Gelband (a rationalist) and Fuld resulted in Gelband's and his subordinate, Kirk's removal from the firm (Fishman 2008). Fuld would not have senior executives question his actions, and therefore simply removed them from their positions. In removing such obstacles, Fuld refixed the relations of membership within the firm as depicted in Clegg's dispositional circuit. Gelband attempted to change the system of decision-making. But changing institutional life is not simple. "To change social relations in the facilitative circuit means mobilising change in fields at the dispositional and episodic levels" (Boje & Rosile 2001, p. 95). Gelband was unable to achieve this given his lower status in the power hierarchy of the firm and therefore succumbed to the authoritative power of Fuld.

Following the announcement of the 31 May 2008 second-quarter earnings - a USD 2.8 billion loss, Fuld finally capitulated to the need for additional capital (Lehman Brothers Holdings 2008c). He reversed his previous tactic and accepted that a rational response was required for the market and announced "the firm was raising USD 6 billion in new capital from blue-chip investors" (Lehman Brothers Holdings 2008g). The press statement quoting Fuld, read as follows:

Since we announced our expected second quarter earnings last week, we have begun to take the necessary steps to restore the credibility of our great franchise and ensure that this quarter's unacceptable performance is not repeated. We have raised an additional USD 6 billion of capital. I have asked Bart McDade, our best operator, to serve as the Firm's president and chief operating officer. I have also asked Ian Lowitt, our co-chief administrative officer, to be our chief financial officer. With these actions and our continued commitment to our client-

driven franchise, we are positioned to take advantage of opportunities that lie ahead, and we are focused on maximizing shareholder value (Lehman Brothers Holdings 2008g).

Again this was an attempt to manage perceptions. It suggested that there was investor appetite for LB equity. Further the statement that Fuld was appointing a new COO (replacing long time COO Gregory) and CFO was intended to portray that the desperate situation would be turned around. Notably there is no mention that Fuld would be stepping aside partially or fully or that he accepted personal responsibility for the results. Again the reluctance to accept responsibility is a form of power over subordinates. This power is evidenced by the differential treatment of his immediate subordinates whose employment was terminated whilst he retained his own position.

The conference call to investors on 16 June 2008 was led by Fuld who was normally absent from such calls announced the second quarter results. At the beginning of the conference call Fuld stated:

Now let me discuss our current asset valuation on those remaining positions. I am the one who ultimately signs off and I am comfortable with our valuations at the end of our second quarter, because we have always had a rigorous internal process (Seeking Alpha 2008).

Fuld started the conference call with a relatively unimportant comment on the valuation of a portion of the balance sheet, instead of commencing with a discussion on the headline poor performance. This was an effort to diminish the relevance or importance of the shocking profit result, and thereby an attempt to manipulate perceptions, again an exercise of power over any potential reaction of stakeholders.

LB's share price of USD 27.20 as at 16 June 2008 (the date of the second quarter results' conference call), was down 104% since 1 January 2008. This drop would have placed many other CEOs in jeopardy of termination. However Fuld was able to survive given his influence over the Board of Directors, "Lehman's Board of Directors, which included retired CEOs like Vodafone's Christopher Gent and IBM's John Akers were reluctant to challenge Fuld as the firm's share price spiralled lower" (Plumb & Wilchins 2008a). See section 10.3 for a discussion of Fuld's power over the Board.

Fuld had steered Lehman through the 1997/98 Asian Financial Crisis, a period where the firm's share price dropped to USD 22 in 1998, but kept his job as the subprime mortgage crisis took hold, while CEOs of rivals like Bear Stearns, Merrill Lynch, and Citigroup were forced to resign (Plumb & Wilchins 2008a).

Power Usurps Coercive Isomorphism in CEO Accountability.

As Plumb and Wilchins (2008a) notes, it was not uncommon in the midst of the global credit crisis for investment banking firms to sacrifice their CEOs following dire results. These organisations reacted to pressure from the markets including investors (both debt and equity),

government agencies and the media generally. This pressure, a form of coercive pressure is a consequence of an expectation of an organisation to act in a certain manner. The act in these cases involves retrenching the leader who is expected to take responsibility for the poor performance of the firm. Oliver (1990, p. 152) describes this as “conscious obedience to the incorporation of values, norms or institutional requirements”. The pressure to replace CEOs for the failing fortunes of a company had affected Bear Stearns, Merrill Lynch, and Citigroup. However Fuld managed to retain his position of Chairman and CEO. How did Fuld achieve this? This is a case where DiMaggio & Powell’s (1983) New Institutional Theory intersects with Clegg’s (1989) Theory of Power.

Although LB succumbed to the coercive isomorphic pressures in appointing a new COO (in the process removing Gregory) and CFO (in the process removing O’Meara), Fuld managed to prevent his own removal through power sourced from an atypical influence over the firm’s Board of Directors. See section 10.3 for further analysis. This power can be placed in Clegg’s dispositional circuit where Fuld’s historic influence over the board and expectation that his every decision would be ratified, was created within the socially constructed environment of board meetings. Within this setting, where relations between members of the board and the chairperson are formal by way of a board charter and informal by way of expected rules of behaviour, it was customary for the board to follow the chairperson’s recommendation. The board’s habitual acquiescence to Fuld’s wishes legitimised his authority. Therefore through the obligatory passage point of the regular meetings, Fuld was able to control the board to generate his desired outcomes. As the board possessed the formal authority to remove the CEO, Fuld’s exercise of power over the board limited the coercive isomorphic pressure within LB of removing him in the face of a financial crisis.

Although Fuld engineered his survival as CEO and Chairman, he started to lose control over LB after a prolonged process of unsuccessfully attempting to turn around the fortunes of the firm. In his role as COO, McDade had begun to assert some authority in view of the firm’s continuing financial crisis. McDade decided to reinstate his colleagues, Gelband and Kirk who had previously warned Fuld of the impending disaster, in an attempt to rescue the firm. “I’m here because of Bart”, Gelband pointedly told Fuld’ (Fishman 2008). This was an example of the first and one of only a few direct challenges to Fuld’s authority, simply because Fuld was perceived as losing his power.

The facilitative circuit is where power and also disempowerment can occur. Fuld continued to hold his CEO and Chairman title and the authority it carries, governed by the hierarchical rules of organisational membership held within the dispositional circuit. However, this became increasingly superficial and was overridden by a process of disempowerment through the facilitative circuit. The desperate financial position of the firm required a new approach as all other attempts to stave off bankruptcy was failing. McDade filled the vacuum of thoughtful leadership left by Fuld. As Fuld was no longer visibly offering practical solutions,

his ability to convince his team and the market that he had the 'knowhow' to save LB had evaporated. This development is consistent with the notion of disempowerment in the facilitative circuit. The perceived knowhow that conferred power to Fuld was no longer evident.

Bear Stearns – Failure of the Hedge Funds and then the Firm

The failure and subsequent rescue of Bear Stearns, the fifth largest investment bank in the US in 2007 based on total revenue – refer Figure 89 for a comparison of total revenue of the five largest investment banks, signalled the beginning of the liquidity crisis which immediately preceded the GFC. It conducted similar business to LB and possessed a similar financial structure especially in a key measure of financial risk - leverage. Bear Stearns was also one of the pioneers in securitising CDOs (Ryback n.d.). Through its subsidiary, Bear Stearns Asset Management (BSAM), it managed two hedge funds which invested in structured CDOs. These funds were managed on behalf of third party investors, however Bear Stearns had also invested approximately USD 25 million into the funds and had loaned the funds approximately USD 1.6 billion (Financial Crisis Enquiry Commission 2011, pp. 240-1).

By April 2007, BSAM's internal risk exposure reports showed that one of the funds: 'High-Grade Structured Credit Strategies Fund' (High-Grade) comprised approximately 60% of subprime mortgaged backed CDOs, assets that were beginning to deteriorate quickly in value (Bear Stearns Asset Management 2007; Ryback 2010). The second fund: 'Enhanced Fund', which was similarly structured, had even more leverage and hence was deemed of higher risk. These funds could only be valued on the basis of a valuation of the underlying assets which comprised subprime mortgage CDOs, and were difficult to value when the market for CDOs became illiquid.

A common practice of tracking the values of such assets was to monitor the ABX Index, described as: "a Dow Jones-like index for credit default swaps on BBB- tranches of mortgage backed securities" (Financial Crisis Enquiry Commission 2011, p. 233). The value of these funds came under pressure as the ABX Index fell 3% in the last quarter of 2006, followed by a 8% drop in January 2007 and a 25% drop in February 2007 (Financial Crisis Enquiry Commission 2011, p. 238). Consequently investors began to redeem their investments in

both funds. In June 2007, the funds' 'Repo lenders'⁵⁵ declined to renew their funding. Despite the abovementioned equity and debt support provided by Bear Stearns, BSAM's parent had no legal obligation to rescue either the funds or the Repo lenders. By July, the two hedge funds had shrunk to negligible value with the High Grade Fund having reduced by 91 and the Enhanced Leverage Fund, down by 100% (Financial Crisis Enquiry Commission 2011, p. 241). On 31 July both funds filed for bankruptcy. The bankruptcy of the BSAM funds would be viewed as a seminal point in the chronology of events of the last days of LB and the GFC generally. In an internal email in June 2007, Bill Jamison of Federated Investors, one of the largest mutual funds in the US, referred to the BSAM hedge funds as the "canary in the mineshaft" (Financial Crisis Enquiry Commission 2011, p. 241). That is, given most of the CDOs in the funds were originally assigned 'AAA' ratings by the credit rating agencies, trust in the ratings and in the safety of similar assets was shattered.

Bear Stearns decided to take responsibility for the Repo contracts originated by the High-Grade Fund. It transferred approximately USD 1.6 billion of the liabilities and respective subprime loans onto its own balance sheet and repaid the lenders. In November 2007, the firm recorded USD 1.9 billion write-down on the subprime assets which prompted investors to examine Bear Stearns' financial statements more closely. Following the release of Bear Stearns' fourth quarter loss of USD 379 million, the firm's lenders progressively required Bear Stearns to lodge a higher percentage value and better quality securities as collateral against their Repo loans, and also charged higher interest rates (Financial Crisis Enquiry Commission 2011, p. 280). On 13 March 2008 a liquidity crisis generated by rapid claims for repayment by lenders forced Bear Stearns to inform the SEC that it would be unable to operate normally the following business day. On 14 March 2008, in response to the elevated of systemic risk arising from Bear Stearns financial difficulties, the Federal Reserve funded a USD 12.9 billion loan channelled through JP Morgan to Bear Stearns. Upon publication of this loan, Bear Stearns' S&P credit rating dropped from 'A' to 'BBB'. At the close of business, Bear Stearns' liquidity had evaporated and its stock price declined by 47% (Financial Crisis Enquiry Commission 2011, p. 289)

⁵⁵ A Repo lender is a lender to a dealer or other holder of securities who sells the securities to the lender (Repo lender) and agrees to repurchase them at an agreed future date at an agreed price, thereby receiving temporary funding – refer footnote 10.

Ultimately the Federal Reserve structured a deal involving JP Morgan Chase whereby the Federal Reserve purchased USD 29.9 billion of Bear Stearns' assets via a special purpose vehicle owned by the Federal Reserve, thus removing the bulk of the toxic assets from the firm's balance sheet. To fund the purchase, the Federal Reserve and JP Morgan Chase loaned USD 28.82 billion and USD 1.15 billion to the SPV respectively. The second leg of the deal involved JP Morgan Chase acquiring the shares of Bear Stearns at a price of USD 10 per share (Financial Crisis Enquiry Commission 2011, p. 290). The deal was so structured as "The Federal Reserve and the Treasury Department would not support a transaction where Bear Stearns' stockholders received any significant consideration because of the moral hazard of the federal government using taxpayer money to 'bail out' the investment bank stockholders" (Financial Crisis Enquiry Commission 2011, p. 290). It was clear that Bear Stearns' failure was precipitated from a liquidity shortage driven by the abovementioned run by creditors. According to Cox (2008b, p. 1), in a letter to the Basel Committee of Banking Supervision relating to 'Sound Practices for Managing Liquidity in Banking Organizations' the Chairman of the SEC, Christopher Cox wrote:

Even at the time of its sale on Sunday, Bear Stearns' capital, and its broker-dealers' capital, exceeded supervisory standards. Counterparty withdrawals and credit denials, resulting in a loss of liquidity, not inadequate capital, caused Bear's demise (Cox 2008b).

The recognition of the importance of liquidity would be a lesson unheeded by LB's leadership team. In response to this concern, the Federal Reserve announced the creation of the Primary Dealer Credit Facility⁵⁶ – a program allowing investment banks for the first time to borrow money directly from the Federal Reserve, which up until then provided liquidity facilities only to registered banks.

Investment banks had been relying on high levels of leverage to raise funds on their balance sheets. This practice was soon highlighted to the stockholders of investment banks and share prices of all the major investment banks began to decline during 2008 (Masood 2009). The problems mentioned above were not only limited to the investment banking industry as any financial institution holding mortgage-related assets, in particular subprime mortgages,

⁵⁶ The Primary Dealer Credit Facility (PDCF) was an emergency credit facility established on 17 March 2008, provided by the Federal Reserve to primary securities dealers whereby the emergency funding was collateralized by a predetermined list of securities.

was negatively impacted. Two government sponsored institutions that faced similar challenges were Fannie Mae and Freddie Mac.

6.4 Fannie Mae and Freddie Mac's Rescue

On 7 September 2008, a week before LB's bankruptcy, the Federal National Mortgage Association, (Fannie Mae)⁵⁷, and the Federal Home Loan Mortgage Corporation (Freddie Mac)⁵⁸ were taken over by the government and placed in a conservatorship which is the equivalence of a managed bankruptcy. Fannie Mae's losses for the full year in 2008, were estimated at between USD 18 billion and USD 50 billion, whilst Freddie Mac's losses were estimated at between USD 11 billion and USD 32 billion by the end of the year (Financial Crisis Enquiry Commission 2011, p. 320). Fannie and Freddie were considered 'too big to fail'. Although privately owned prior to their takeover, these institutions were known as government sponsored enterprises (GSEs) as they purportedly undertook activities supported by the government in supporting the supply of new mortgages to the US public. These GSEs were highly leveraged, with mortgage exposures of USD 5.3 trillion backed by capital of under 2% (Financial Crisis Enquiry Commission 2011, p. 309).

The rescue of the GSEs involved a complex arrangement. Firstly, the Treasury would buy USD 200 billion of senior preferred stock issued by the GSEs and extend them short term secured loans. In addition, it pledged to buy GSE mortgage backed securities from the investment banking industry and others until the end of 2009. Immediately, Treasury bought USD 1 billion in preferred stock with a 10% dividend. The deal also involved the issuance of warrants over common stock to the Treasury representing 79.9% of the stock outstanding (Financial Crisis Enquiry Commission 2011, p. 320). In effect this rescue effort resulted in the government owning a majority of the GSE's ordinary stock and all of their preferred stock.

⁵⁷ Fannie Mae was created following the Great Depression as a government instrument to securitise mortgages, thereby creating capacity on bank balance sheets allowing the to undertake further lending.

⁵⁸ Freddie Mac was founded in 1970 as another government instrument to expand on the same functions as Fannie Mae.

Notwithstanding the loss to equity investors, Treasury had once again managed to stave off a major crisis by direct intervention and the use of taxpayers' funds.

6.5 Lehman Brothers' Last Weekend

As mentioned above, investment banks relied heavily on short-term debt in order to operate. Given their businesses mostly involved dealing with counterparties who would necessarily incur risk to the firm, the continuing rolling over of short term debt depended on counterparties' faith in the firm's ability to honour their obligations. As soon as the customers and creditors began to query the sustainability of the firm they became less willing to lend or trade and either reduced their credit and/or trading limits or even worse, sought full repayment of outstanding loans (Financial Crisis Enquiry Commission 2011).

Within weeks of LB's second quarter earnings release on 16 June 2008, several major financial institutions had reduced their exposure to the firm. These included "Natixis, a French investment bank that cut all activity with LB; Federated Investors - a large money market fund and one of LB's largest Repo lenders which had frozen all new transactions; other large pension funds and some smaller Asian central banks" (Financial Crisis Enquiry Commission 2011, p. 328). The perception of weakness exacerbates the reality of weakness within an industry that relies on confidence between counterparties. Importantly, one of the most visible measures of a firm's weakness is a declining share price. As mentioned above, LB's share price of USD 27.20 as at 16 June 2008 (the date of the second quarter results' conference call), was down 104% since 1 January 2008. By 29 August, 2008, LB's share price had declined further to USD 15.20 (Investorpoint Investor Information Systems 2016). During this month, Fuld finally realised that the firm required a rescue plan and proceeded to search for a buyer for the firm. "We contacted virtually every financial institution in the world with the interest and capacity to deal, says a person close to the process" (Fishman 2008). Despite several attempts to find a buyer, the most serious of which was Barclays Bank in the UK, there were no institutions willing to invest in a less than transparent entity where asset values were obscure at best.

In a speech in April 2008 David Einhorn of Greenlight Capital, which was then shorting LB's shares, and was an analyst who closely investigated LB's accounting practices commented on LB's real estate loans:

Lehman does not provide enough transparency ... There is good reason to question Lehman's fair value calculation. Lehman responds to greater transparency begrudgingly. I suspect that greater transparency on these valuations would not inspire market confidence (Einhorn 2008b, p. 9).

In a foreboding presentation, Einhorn's discovery of accounting discrepancies also led him to comment as follows:

My hope is that Mr. Cox and Mr. Bernanke and Mr. Paulson will pay heed to the risks to the financial system that Lehman is creating and that they will guide Lehman toward a recapitalization and recognition of its losses – hopefully before federal taxpayer assistance is required...I think that there is enough evidence to show how Lehman answered the difficult question as to whether to tell the truth and suffer the consequences or not. This raises the question, though, of what incentive do corporate managers have to fully acknowledge bad news in a truthful fashion? For the capital markets to function, companies need to provide investors with accurate information rather than whatever numbers add up to a smooth return. If there is no penalty for misbehaviour- and, in fact, such behaviour is rewarded with flattering stories in the mainstream press about how to handle a crisis - we will all bear the negative consequences over time. At a minimum, what message does this send to some of Lehman's competitors that probably didn't have problems quite as acute as Lehman, but who took sizable write downs, and diluted their shareholders with significant equity raises? (Einhorn 2008a, p. 9).

JP Morgan Chase was LB's clearing bank and in this capacity acted as the banking intermediary between LB and its Repo lenders. As well as providing credit from time to time, JP Morgan Chase ran overnight exposures in the day to day activity of settling the firm's Repo transactions. On Tuesday September 9, 2008 JP Morgan Chase requested USD 5 billion in extra collateral. Instead, LB offered USD 3.6 billion which allowed it to operate for at least some time longer (Financial Crisis Enquiry Commission 2011). It was obvious that if LB did not lodge the extra collateral, JP Morgan Chase would essentially freeze its accounts and LB would cease trading. JP Morgan Chase had clients (the Repo lenders and other counterparties relying on it as LB's clearing bank) whose interests it had to defend.

Fuld continued to deflect responsibility for LB's difficulties claiming Jamie Dimon, JP Morgan Chase CEO, "was doing whatever was in his own personal interest. He knew the consequence was a huge blow to us, and he didn't give a shit...they drained us of cash...They fucked us" (Fishman 2008). This quote reveals Fuld's focus on personalities instead of the institutional relationship between JP Morgan Chase and LB. Fuld had resorted to personalise LB's problem making Dimon the source of LB's crisis instead of rationally examining LB's culpability and the underlying reasons for the firm's financial crisis. This emotional irrationality can be seen as an example of Fuld's state of mind at the time and his propensity to blame individuals who didn't conform to his own expectations of practice. Fuld's power had been challenged and he didn't like it.

On Wednesday, September 10, 2008, LB reported a third quarter loss of USD 4.09 billion for the quarter ending 31 August 2008. This loss together with the previous second quarter loss of USD 2.87 billion for the quarter ending 31 May 2008, was accounted for after applying the newly released accounting standard, Statement of Financial Accounting Standards No.

157, (FAS 157). FAS 157 which applied to corporations after November 15, 2007, essentially required financial assets to be brought to account at 'fair value'⁵⁹ which was interpreted by the finance industry as market value. As a result of this new definition, and given the deterioration in the market value of LB's assets, it brought to account the accompanying devaluation losses in the profit and loss statement (Financial Accounting Standards Board 2006a).

Simultaneously, in an effort to generate cash, Fuld developed a strategy to dispose of both the Investment Management Division and its distressed real estate portfolio. In an attempt to calm market sentiment, and in a tone of confidence and control, he announced to the market that the firm would recover: "We have a long track record of pulling together when times are tough...we are on the right track to put these last two quarters behind us" (Fishman 2008). More bad news was released to the market as potential investors in the firm retreated. When negotiations for an investment from the Korea Development Bank ceased, the market became increasingly wary of Fuld's ability to execute a survival strategy (Financial Crisis Enquiry Commission 2011, p. 330).

On Thursday 11 September, 2008, JP Morgan Chase once again demanded LB post another USD 5 billion in cash collateral. In an internal email circulated on Friday, 12 September, 2008, LB executives were informed that "If we don't provide the cash [to JP Morgan Chase], they refuse to clear, we fail" (Financial Crisis Enquiry Commission 2011, p. 333). In a desperate attempt to stave off a default claim by JP Morgan Chase, LB undertook a fire sale of assets. It posted the USD 5 billion cash by selling virtually all remaining unencumbered financial asset it owned (Financial Crisis Enquiry Commission 2011, p. 333).

Starting Friday night, September 12, 2008 and continuing throughout the ensuing weekend, a series of meetings were convened at the Federal Reserve offices. These meetings involved US Treasury Secretary, Hank Paulson, the President of the New York Federal Reserve, Timothy Geithner, a number of government and regulatory officials and CEOs of the major US commercial and investment banks. Also attending some of the meetings representing LB were McDade and Kirk. Fuld was not invited to the meetings (Financial Crisis Enquiry Commission 2011, p. 334).

⁵⁹ FAS 157 altered the meaning of fair value. "Fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability" (Financial Accounting Standards Board 2006a).

Various options to rescue LB were discussed, including plans for sovereign wealth funds, Bank of America (BoA) and Barclays Bank to absorb LB in one form or another. However all negotiations failed due to potential rescuers requiring a government guarantee or investment (as occurred in the Bear Stearns rescue package), protecting them from the potential losses resulting from the toxic assets. It became clear that the government's position as represented by Paulson and Geitner was not to inject any capital or provide other support by way of a guarantee to potential investors. According to Paulson, the assistance for LB:

should be done in a way that requires minimal temporary support. . . no equity position by [the] Fed. Moral hazard and reputation cost is too high. If the Fed agrees to another equity investment, it signals that everything [the Fed] did in March in terms of temporary liquidity backstops is useless. Horrible precedent... bankruptcy, would be a mess on every level, but fixes the moral hazard problem (Mosser 2008).

Further for Paulson, "such a guarantee by the Fed was unequivocally out of the question" (Paulson 2011, pp. 209-10). During the weekend, news spread of the financial difficulties of another major investment bank, Merrill Lynch. Further to a meeting between John Thain, CEO of Merrill Lynch and Ken Lewis, CEO of BoA, an agreement was reached whereby BoA would acquire Merrill Lynch by paying USD 29 a share. The payment to Merrill Lynch shareholders was to be made in BoA shares (Financial Crisis Enquiry Commission 2011, p. 335). Having participated in the weekend's meetings relating to LB, Thain was concerned that Merrill Lynch would soon follow LB into bankruptcy and therefore sought a rescue and agreed to the terms offered by BoA.

At the conclusion of meetings on Sunday night 14 September 2008, McDade returned to LB's head office with feedback to Fuld and the board that Geitner and Paulson had recommended the firm file for bankruptcy given that no rescue package had come to fruition. This news surprised the executives as the hubris which enveloped Fuld and others had blinded them to the ultimate possibilities of a bankruptcy. "Dick never believed zero was an option. He believed at the end of the day, good guys win" (Fishman 2008). Fuld's denial of the severity of the problem persisted until the very end as he was convinced he was one of the 'good guys'. The next day, at 1.45am on Monday morning, LB filed for bankruptcy.

6.6 The shifting Nature of Power and Institutional Influence

A combination of 'exogenous environmental'⁶⁰ and endogenous factors conspired to shift the direction of power away from Fuld and his senior executive team and heightened an institutional shift away from the neoliberalist approach adopted by the government and regulators towards an increasingly interventionist approach with some incongruous consequences for LB.

6.6.1 Endogenous Factors

Endogenously, the deteriorating performance of LB during 2007 and 2008 resulted in two significant outcomes. Firstly, the deteriorating performance of LB led to greater scrutiny of the firm, which precipitated increased market pressure to become more transparent. The resulting scrutiny in turn prompted the market to sell LB shares, adversely affecting the value of the firm.

Secondly, an inconsistent bonus outcome for a segment of LB's staff caused a degree of resentment which disrupted the historically resilient loyal relationship between employees and Fuld. These endogenous factors contributed to the shift of power between the two groups. The power previously held by Fuld and his well-compensated senior executive team had shifted to the firm's other stakeholders, including its lower level employees.

Poor Performance Increases Scrutiny

The poorer performance during 2007 and 2008 created an atmosphere of disappointment, uncertainty and even scepticism amongst stakeholders including creditors, stockholders and their securities analysts. The actions of LB and its key executives experienced greater scrutiny by external observers especially the security analysts, such as Einhorn. The common per-

⁶⁰ Refer (Clegg 1989) The Exogenous Environmental stimulus can affect both the facilitative and dispositional circuits.

ception that the longest serving CEO on Wall Street, 'could do no wrong' gradually disappeared. Fuld's ability to make uncontested decisions was diminishing.

A study by Petukh (2009), found a reversal in broker recommendations from a positive stock 'buy' recommendation before the release of LB's 2008 second quarter results to either a neutral 'hold' or negative 'sell' recommendation afterwards. As analysts grew wary of LB's financial position their level of scrutiny over the firm increased. "They tracked every decision made by management and reported on positive and negative effects" (Petukh 2009, p. 32).

Fuld Loses Power over Commentators

Fuld's social relations within and outside the firm (the agencies in Clegg's circuits of power) were weakening thereby reducing his means of directing outcomes. The increasing vigilance of securities analysts and the media demonstrated through their respective actions of shorting LB's shares and increasing negative media reporting, transformed the rules within which LB was accustomed to operate.

The pressure for enhanced transparency is interpreted as a refixing of the rules contained in Clegg's dispositional circuit. Transparency was required in the release of the third quarter financial results. The USD 4.09 billion loss represented the outcome of a newly refixed 'transparency' rule transmitted through the obligatory passage point of the newly released accounting standard on 'fair market value'. The social relations between analysts and LB's financial control executives had changed and trust in LB's financial reporting had lessened.

Pursuant to the new accounting standard FSAS 157, LB was pressured to disclose more details than usual, resulting in a clearer picture of their true financial predicament. In the process of disclosing financial statements with greater transparency, a shift of power occurred from Fuld and his team to the external agencies comprising LB's stakeholders and the media. The new holders of power were finally able to make informed decisions based on a true and fair position of the firm.

Reduction of Bonuses Causes Resentment

The second endogenous factor is associated with the first and relates to bonus compensation. The declining performance of LB involved a commensurate decrease in compensation paid to employees. Throughout his tenure at LB, Fuld was admired by his employees (McDonald & Robinson 2009). Even from a distance Paulson observed that Fuld "was direct and personable, a strong leader who inspired and demanded loyalty, but like many founders his ego was entwined with the firm's. Any criticism of Lehman was a criticism of Dick Fuld" (Paulson 2011, p. 123). Hence, whilst LB performed strongly and paid generous bonuses,

Fuld engendered gratitude and loyalty. Since the firm's listing, LB produced profits in each year until 2008, thereby perpetuating the strong loyalty held by Fuld.

Once the firm began experiencing financial distress in 2007, from a share price and balance sheet perspective, there were signs of dissention within the ranks of LB. This was exemplified by Gelband's and Kirk's attitudes towards LB's elevated risk profile and their willingness to confront Fuld with their concerns. The dissention, although only acted upon by very few such as Gelband and Kirk who were pressured to leave the firm, was affecting numerous employees.

Despite the dramatic share price decline in the second half of 2007, the year was deemed successful from a financial reporting perspective. LB reported a record net profit after tax for the year ended 30 November 2007 of USD 4.13 billion (up by 5% from the previous year) and total revenue of USD 59 billion (up by 26% over the previous year). 2007 represented the fifth consecutive year of record profits. When the bonus pool was announced for 2007, many employees were left dissatisfied. Lawrence McDonald, the Vice President of Distressed Debt and Convertible Securities at LB during 2007 commented on Fuld and Gregory as follows:

It was however perfectly obvious that the two leaders had nothing but contempt for us. And when they sat down to work out the bonuses, they screwed us all. The traders' standard agreement on Wall Street had been a USD 20 million profit to earn a USD 1 million bonus. That went straight out the window. My bonus, after my second straight USD 30 million a year was way down, nowhere near my expectations. It was the same all through the department. Dick [Fuld] and Joe [Gregory] just cut us all back- Beggans, Gramins, Schellbach, Stafford, Castle. And now we had no one to fight for us (McDonald & Robinson 2009, p. 274).

Although the Total Annual Compensation Report dated 28 January 2008 shows a number of executives with increased bonuses, a degree of resentment such as that displayed by Lawrence MacDonald persisted from some quarters within LB. The resentment would have been amplified once staff discovered that Fuld and Gregory had received record bonuses in 2007 of USD 40 million and USD 34 million respectively (Lehman Brothers Holdings 2008f). Dissatisfaction at this disparity in compensation levels between Fuld and Gregory and the rest of the staff prompted further challenges to Fuld's authority. Consequently the power that Fuld exercised by virtue of being the principal largely responsible for fixing the rules relating to compensation arrangements, had begun to diminish as disaffected staff viewed the exercise of this power as being inequitable and unfair.

6.6.2 Exogenous Factors

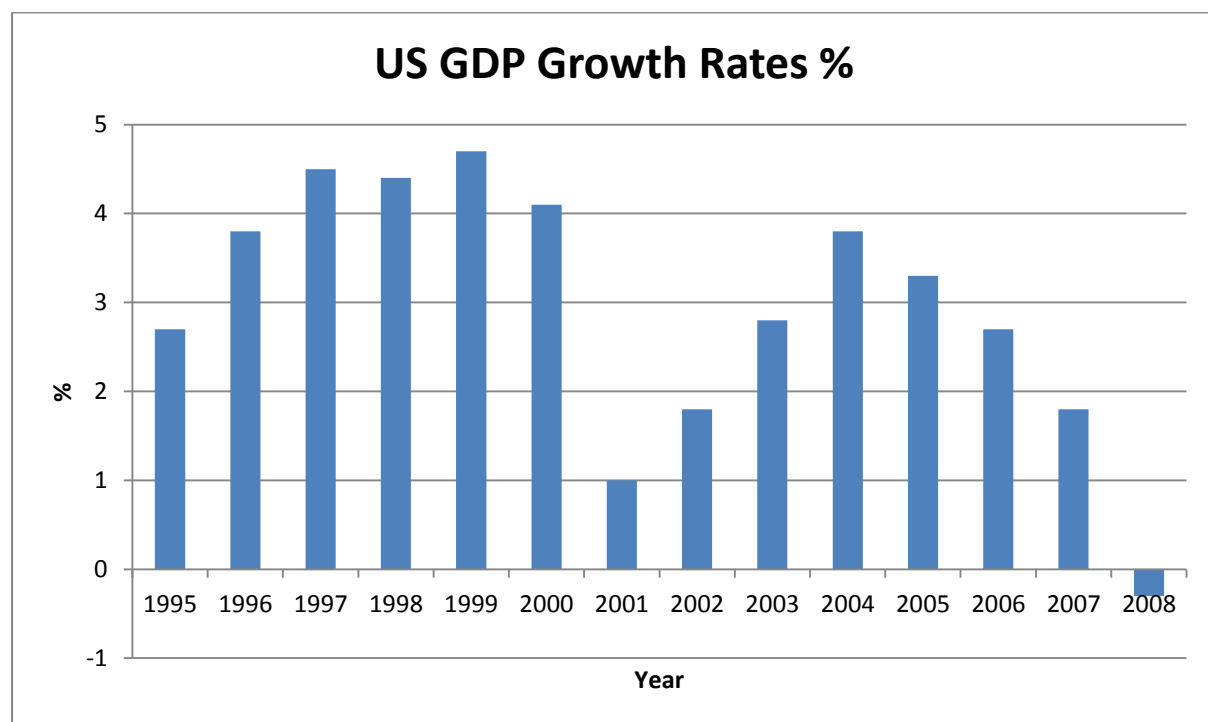
The exogenous environment influencing Fuld's power base included the political atmosphere, the social relations between the investment banking industry, key regulators, politicians, and the economic climate. Each of these factors would influence Fuld's power in their

interaction as external exigencies through either the dispositional or facilitative circuits as explained below.

Economic Climate

Despite experiencing a cyclical downturn in 2001, the US economic climate from 1994 to 2007 had been positive without recording any negative Gross Domestic Product (GDP) growth rates (Figure 84).

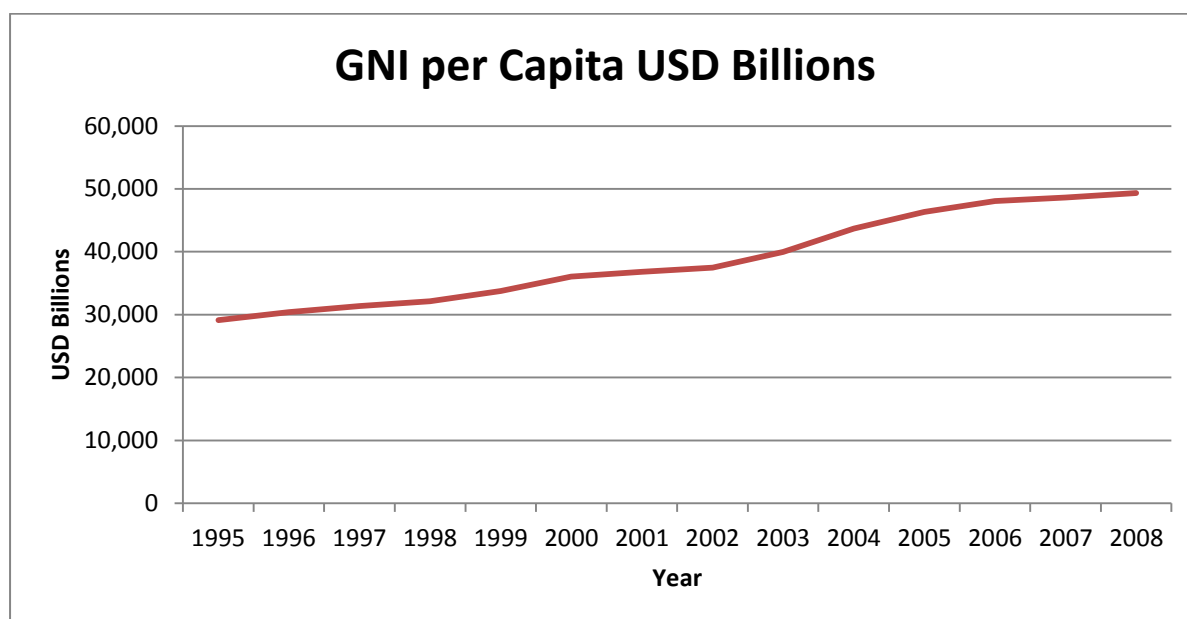
Figure 84 - US Economic Growth 1994 - 2008



Source: The data used for the graph was extracted from World Bank, International Comparison Program database, (World Bank 2016).

This pattern of prosperity is confirmed as measured by Gross National Income (GNI) per capita which also improved consistently up to 2008 (Figure 85).

Figure 85 - US GNI per Capita 1994 – 2008



Source: The data used for the graph was extracted from World Bank, International Comparison Program database, (World Bank 2016).

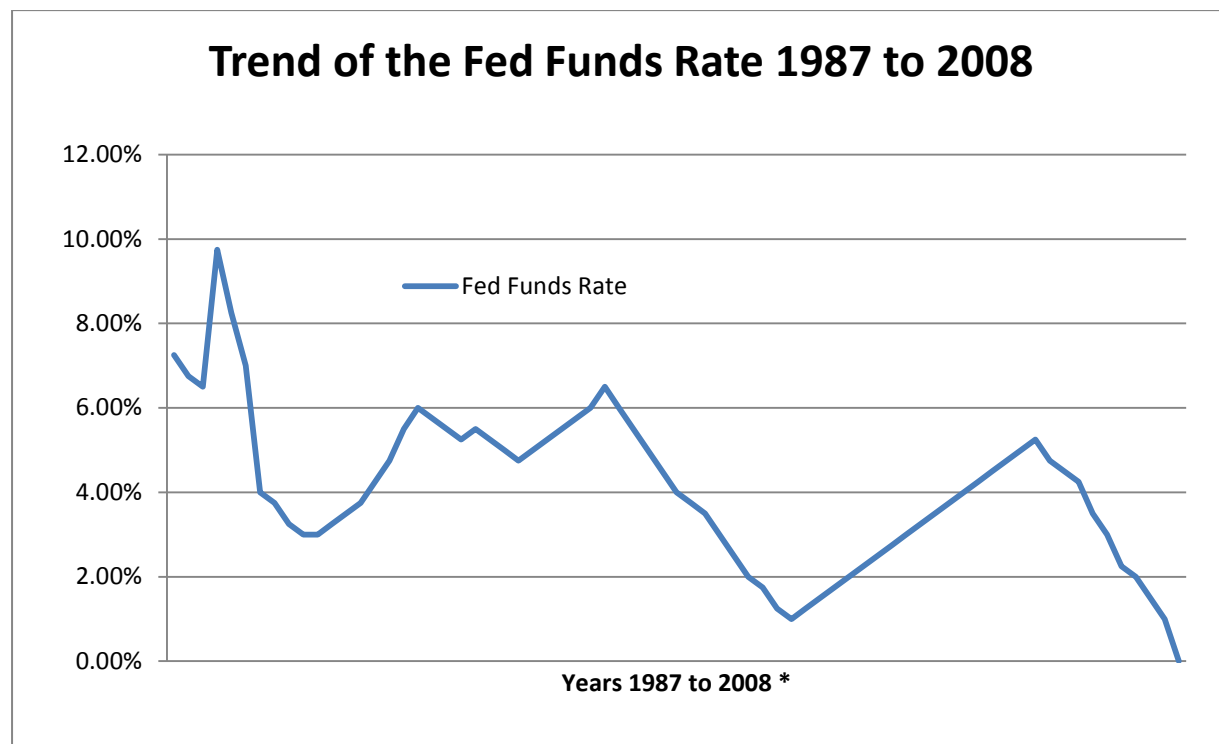
From 2001 onwards, a credit bubble started to appear in the US. Significant amounts of capital moved into the US in search of higher returns. Much of the imported capital was directed to the financial institutions sector and used to fund home mortgage lending. A housing bubble was in the making, and through the process of securitisation, financial institutions replenished their balance sheet borrowing capacities and poured further money into the housing market. Refer CHAPTER 2 for a more detailed description of the economic environment leading to the GFC.

The positive economic climate prevailing at the time of Fuld's leadership had convinced the various successive federal governments in the US to continue to pursue a neo-liberal approach spurred by its champion, Ronald Reagan who was the 40th President of the US from 1981 to 1989. This approach was characterised by a 'low regulatory touch' and whilst the investment banking industry was thriving, a laissez faire attitude towards regulation allowed the markets to virtually self-regulate. See section 2.1 discussing the SEC capital rule applying to US investment banks which was voluntary in nature (Financial Crisis Enquiry Commission 2011; Swedberg 2010). This political environment known as 'Reaganomics' at its inception, provided relative autonomy to the industry and as shown in section 8.2.2, allowed the powerful lobby group to successfully prosecute the industry's objective of influencing the regulatory framework.

Further, Alan Greenspan, the Federal Reserve Chairman during the period between 1987 and 2006, pursued an accommodative monetary policy which continued to support asset

markets. The resultant lower interest rates permitted a cheaper financing of asset purchases including property contributing to the abovementioned property bubble of 2008. Refer Figure 86 for a graph charting the declining trend of the Federal Reserve Funds Rate (Fed Funds Rate)⁶¹ during this period.

Figure 86 - Fed Funds Rate 1987 to 2008



* For detailed changes in the Fed Funds Rate refer to Appendix D.

Source: Data for graph sourced from Federal Reserve Bank of St. Louis FRED Economic Data, (Federal Reserve Bank of St Louis 2016).

⁶¹ The Fed Funds Rate is a target interest rate set by the Federal Reserve System at which, through open market operations, The Federal Reserve influences the interest rate at which US depository institutions lend USD to each other from their reserve balances on an unsecured basis. This interbank rate is known as the effective federal funds rate.

Economic Climate as an Exogenous Factor in the Facilitative Circuit

The economic climate, an exogenous factor, as depicted in Clegg's (1989) facilitative circuit was the external stimulus to empower the industry. The power to influence regulation by the investment banking lobby group met little resistance in the laissez-faire environment and the lobbyists who carried out the wishes of the industry represented the obligatory passage point between the facilitative circuit and the episodic circuit where the influence on legislators was exerted. Since Fuld, as Chairman of one of the largest firms on Wall Street, represented a key player in the industry, power facilitated by the economic climate, also flowed to him.

However as soon as the positive US economic climate began to turn during 2007/2008, the liberal approach previously adopted by regulators and legislators reversed. The Treasury and Federal Reserve were attempting to update the regulatory framework to ensure the activities and leverage of investment banks were effectively supervised and to attempt to rein in the expanding risk profile of participants. These actions were an acknowledgement that regulators had lagged the changing practices and progress of innovation within the industry (Johnson & Kwak 2011; Paulson 2011). The regulatory structure, based on traditional lines had not kept up with the evolution of the markets, which was acknowledged by Paulson as follows: "As a result, the country had a patchwork system of state and federal supervisors dating back 75 years...which had led to counterproductive competition among regulators, wasteful duplication in some areas and gaping holes in others" (Paulson 2011, p. 125).

Accordingly, in March 2008, Paulson unveiled the 'Blueprint for a Modernised Financial Regulatory System' (Paulson et al. 2008). This document proposed a new regulatory structure, not new regulations, though Paulson admitted that "we clearly needed some" (Paulson 2011, p. 126). Despite the efforts in preparing this report, Paulson emphasised that "no major regulatory changes should be enacted while the financial system was under strain" (Paulson 2011, p. 126).

Political Atmosphere

Following the government's bailout of Bear Stearns earlier in 2008, the government detected a backlash from the public to the use of taxpayer funds to bailout private industry. Moreover, an investment bank whose employees were remunerated far in excess of the US average wage represented the worst aspect of greed and avarice. See sections 6.6.1 and 10.5 for a detailed analysis of investment banking remuneration. This perception was heightened after the taxpayer funded rescue of Fannie Mae and Freddie Mac and the expansion of industry assistance provided by way of the PDCF. Treasury's major concern at this time was the moral hazard created following these government assisted bailouts. On 10 September 2008, Paulson and Geithner agreed that LB should not be bailed out:

All of us were well aware that after Fannie and Freddie, the country, Congress, and both parties were fed up with the bailouts. Obama and McCain, neck and neck in the national polls, each spoke out against them on the campaign trail. The previous day in fact McCain and Palin had published an op-ed in the Wall Street Journal entitled 'We'll Protect Taxpayers from More Bailouts'. And just before our conference call had begun I'd spoken with Chris Dodd⁶² who told me, Fuld is a friend. Try to help, but don't bail Lehman out (Paulson 2011, p. 181).

Being spurred and influenced by politics, Paulson and Geithner heeded Dodd's advice. Paulson had also agreed with Cox from the SEC and Bernanke from the Federal Reserve that as representatives of the key regulatory authorities involved in the US financial system, they should keep close communication, and co-ordinate and seek consensus on all meaningful decisions and actions (Paulson 2011). Therefore any legislative initiative by any one of them is deemed to have tacit approval from all three authorities before enactment.

Dodd as Chairman of the Senate Banking Committee was perceived within and outside of government as the political thought leader in the financial system. Therefore he possessed authority within the dispositional circuit given his ability to influence rule making and the meaning of those rules, and fixing relations of membership between government and regulators. Ultimately, Dodd's power was facilitated by his influence over the US President's appointment of The Secretary of the Treasury, the two Under Secretaries, an Under Secretary for Enforcement, and two Deputy Under-Secretaries. The President relies on the Senate for his recommendations and the Senate was strongly guided by the Chairman of the Senate Banking Committee who at the time was Dodd (*U.S. Code - Department of the Treasury* 1947).

Changes in Social Relations between Industry and Government within the Episodic Circuit

Changes of social relations between agencies at the episodic level have the potential to impact on the degree and direction of power to generate a different outcome. The social relations between LB and the regulatory community had changed during the onset of the crisis,

⁶² Christopher Dodd, a US Democrat, served in the US House of Representatives from 1975 to 1981, and the US Senate from 1981 to 2011. He is well known as the Chairman of the US Senate Banking Committee from 2007 to 2011. He held several other prominent positions on Government committees and was also a qualified lawyer, and had previously worked as a lobbyist.

resulting in outcomes detrimental to LB. Paulson had known Fuld for many years, given Paulson was ex-CEO of Goldman Sachs prior to his appointment as the Treasury Secretary. Paulson (2011, p. 155) expressed concerned about LB and claims that he “kept an eye on Lehman’s travails, speaking regularly with Dick about his options. The best of these were to sell his firm”. Paulson’s call log would show nearly fifty discussions with Fuld in the six months between Bear Stearns’ failure and LB’s collapse, and his staff would have had at least as many calls (Paulson 2011, p. 137). On 9 September, Paulson expressed his frustration with Fuld in a conversation with Ken Wilson⁶³:

Does he [referring to Fuld] know how serious the problem is? I asked? He’s still clinging to the view that somehow or other the Fed has the power to inject capital. Ken answered. I felt a wave of frustration. Tim Geithner and I had repeatedly told Dick that the government had no legal authority to inject capital in an investment bank. That was one reason I had been pushing him to find a buyer since Bear Stearns failed in March. Fuld had replaced Lehman’s top management, laid-off thousands of employees, and pitched restructured ideas, but the firm’s heavy exposure to mortgage-backed securities had discouraged suitors and had left him unable to make a deal. Ken had been telling Dick [Fuld] with increasing urgency that he needed to be ready to sell, but Dick did not want to consider any offer below USD 10 per share. Bear Stearns had gotten that, and he would accept nothing less for Lehman (Paulson 2011, p. 173).

Despite Paulson’s repeated efforts at attempting to convince Fuld to sell LB, a sale was never consummated. This thesis argues that the personal antipathy and frustration towards Fuld by Paulson over this inaction promoted an increasing indifference towards the survival of LB. After all, Fuld was placing the financial system at risk – a financial system over which Paulson had stewardship. Fuld had unsuccessfully negotiated with several potential suitors including Berkshire Hathaway, General Electric, Bank of America, Korea Development Bank, the Chinese government owned Citic Securities, Deutsche Bank, Morgan Stanley, HSBC and some middle eastern sovereign wealth funds, however most negotiations failed as a result of Fuld wanting too high a price (Johnson & Kwak 2011; McDonald & Robinson 2009; Paulson 2011). Paulson’s frustration and possible antipathy towards Fuld was clear: “It was

⁶³ Ken Wilson was an advisor in the US Department of Treasury. Prior to taking up his governmental advisory position, he was Vice Chairman, Investment Banking of Goldman, Sachs & Co. and a member of the firm’s Executive office.

clear to Ken and me [Paulson] that Dick [Fuld] was looking for an unrealistic price” (Paulson 2011, p. 158). This attitude could be considered as contributing factors to Paulson’s attitude towards allowing LB to fail.

As the Treasury Secretary, Paulson had significant powers under legislation to protect the financial system. Within the facilitative circuit, the legislation constitutes an exogenous stimulus. Paulson’s power differed between that available to enforce legislation and to influence any change in legislation. The power to enforce is afforded within the dispositional circuit given his role as head of the Treasury department and his intimate knowledge of the applicable laws. The power could flow through to the episodic circuit where the implementation and enforcement of the existing legislation could direct the behaviours of the industry participants.

Paulson was however seeking to introduce new legislation to deal with the new financial industry environment, particularly with entities dealing in derivatives. His power to change legislation, however, was limited. This power is generated within the facilitative circuit and requires agreement by both houses of Congress. To channel power to the episodic circuit, Congress would need to exercise its dispositional power inherent in its authority to enact legislation. The power would then need to pass through the facilitative circuit to empower the external government agencies to enforce the applicable legislation. Paulson realised that to push for any new legislation, he would need political support within both houses of Congress. This power was concentrated within two committees, the House Financial Services Committee and the Senate Banking Committee. Paulson acknowledged the lagging regulatory response:

The financial world had changed – with investment banks and hedge funds playing increasingly critical roles – but our [Treasury Department] powers and authorities had not kept up to date (Paulson 2011, p. 138).

In his attempt in July 2008 to establish new legislation to deal with troubled investment banks, Paulson sought the advice of Barney Frank,⁶⁴ Chairman of the House Financial Services Committee:

Barney Frank was supportive but cautioned us against trying to push legislation that was so complex substantively and politically. We concluded that there was no way we could get what we needed passed... We knew it wasn't going to be easy to work with the authorities we had... Instead Barney encouraged the Fed [Federal Reserve] and Treasury to interpret our existing powers broadly to protect the system, saying: If you do so, I'm not going to raise legal issues (Paulson 2011, p. 139).

Furthermore, Paulson complained: "I'm being called Mr. Bailout. I can't do it again" (Wessel 2010, p. 14). Geithner added: "There is no political will for a federal bailout" (Wessel 2010, p. 16). The lack of political will through either of the government's representative bodies, the House Financial Services Committee and the Senate Banking Committee, to introduce new legislation specifically to deal with LB's difficulties without necessitating bankruptcy signalled a change of attitude. This attitude had the effect of disempowering the investment banking industry, by limiting its options to survive a crisis.

6.7 The Wash-up

Following LB's declaration of bankruptcy, liquidity in the financial markets had evaporated and securities began to trade at heavy discounts. The Treasury department realised it needed to secure funding to buy the toxic securities held in the market to prevent a wider meltdown. This was enabled by new legislation known as the Emergency Economic Stabilisation Act which was passed on 3 October 2008.

In addition, the Federal Reserve committed trillions of dollars to an expanding list of liquidity programs intended to support the financial system. These included the Term Auction Facility, the Term Asset-Backed Securities Loan Facility, The Money Market Investor Funding

⁶⁴ Barnett 'Barney' Frank, a US Democrat, served in the US House of Representatives from 1981 to 2013. He also served as Chairman of the House Financial Services Committee from 2007 to 2011.

Facility, and the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility. The considerable government assistance would become the largest industry support package in US history. The US government realised the dire consequences to the larger economy if it was not prepared to act. The ultimate irony of this turn of events was that the support was directed to an industry which had for decades rejected and lobbied against government intervention. Policymakers who once espoused a minimalist approach to industry supervision were encouraging intervention.

6.8 Summary

This chapter analyses the contributing factors immediately preceding LB's collapse such as the role played by innovation which included the use of CDOs and their credit downgrading; the practice of warehousing mortgage related assets, which left LB overexposed to this asset class and placed them in a precarious financial position; the lack of sufficient transparency by LB, considered important to maintain investor confidence; and the effect on LB's share price once confidence in them was lost. This chapter further reveals evidence of the behaviour of some LB employees and Fuld himself towards external partners in their attempts to stave off a crisis. Fuld's reaction to the firm's difficulties was subject to institutional influence and his attempts at an expansion strategy and denial of his own accountability is shown as an exercise power. The regulator's contrasting attitude towards other troubled financial institutions and LB reflected the shifting nature of power between LB (including the industry) and the regulators to reveal why LB was allowed to fail whilst other contemporary institutions were saved. The dysfunctional behavioural and cultural influences on LB had established the foundation for a series of decisions which led to a deterioration of its risk profile which ultimately caused its bankruptcy. The impact of these decisions, are manifested in the financial structure and business model of the firm which is described in CHAPTER 7.

CHAPTER 7 **OVERVIEW OF ORGANISATIONAL AND FINANCIAL STRUCTURE**

7.1 Introduction

The previous chapter covered the period prior to LB's collapse, analysing the institutional influences on it and the dysfunctional exercise of power and how these informed management decisions which affected the firm's ongoing operations. This chapter examines the investment banking industry's shared business model, analysing it through the lens of DiMaggio & Powell's (1983) New Institutional Theory. Together with a financial overview of LB and its peer group, the chapter identifies mimetic pressure as the key influence on LB's business activities and financial structure. The mimetic influence explains why all the major US investment banks experienced similar financial difficulties albeit to various degrees. Further, this chapter argues that the excessive leverage LB accumulated was a root cause of its failure.

This chapter illustrates the extent to which LB and some of its peers reached a critical level of risk. In an effort not to underperform relative to their peers, the investment banks largely gravitated towards a common business model and financial structure. Any underperformance would jeopardise access to capital, new customers and potential employees with valuable skills. As a result, and in the common pursuit of growth, the peer group pursued the leverage effect as an easy mechanism to increase profitability. The institutional influence on the industry is reinforced by the common consequence of a weakening of their financial position where the investment banks pushed their leverage to unsustainable levels.

Section 7.2 describes LB's business model as a one stop shop servicing the needs of a full array of clients from the corporate, governmental, institutional and retail sectors. It argues that the business model was subject to a mimetic influence which resulted in a very similar business model and activities adopted by the other large US investment banks. Section 7.3 provides an overview of the financial structure of LB, which focuses on the firm's trend in profitability, which increased from 2004 until 2007, culminating in significant losses in the last two fiscal quarters in 2008 preceding its collapse. The losses coincided with an increasing reliance on the firm's risky business of securities trading. This section also reveals LB's increasing leverage ratio during the period based on a capital structure which included some items of capital which, in nature, resembled debt. If this capital was reclassified as debt, a higher leverage ratio would have resulted. Finally, it is argued that the combination of increased debt and the use of securitisation and credit derivatives was a popular means of

maximising profits amongst all investment banks. This common approach to exploiting the leverage effect is reflected in a range of similar returns generated by the peer group and supports the notion of a mimetic pressure amongst the banks to pursue similar strategies in their profit maximisation objectives.

7.2 LB's Business Model

This section outlines LB's business model and finds similar business models operating within the industry. The financial structure of LB is a consequence of its business model, strategy, activities and financial transactions. Business models adopted by the investment banks were found to be subjected to a mimetic influence. In their efforts to compete for valuable resources such as capital, reputation, prestige, skills and gain new customers, they attempted to avoid a negative perception associated with an underperforming firm. This is consistent with the notion supported by Hasse and Krücken (2008) that firms examine and mimic the practices of peer group participants in attempts not to be perceived overtly different. . This strong desire not to be perceived as a low ranking firm spawned a practice of replicating product and services offered by competitors, which resulted in similar divisional organisational structures between firms. However under financial pressure towards the end of its corporate existence, Fuld deviated slightly from the traditional model by expanding a riskier segment of its business in the hope of generating superior returns in an uncertain environment.

By 2006, like many of its peers, LB operated in three major business segments. Firstly, it operated a division principally involved in investment management which included departments such as: Private Investment Management, which targeted products particularly towards the retail market such as high net worth individuals; Institutional Asset Management which involved the management of portfolio investments on behalf of institutional, corporate and individual clients; Private Equity where the firm invested in the equity of businesses on behalf of, and alongside its customers; and Securities Services which involved brokerage activities on behalf of clients (Lehman Brothers Holdings 2008j, p. 8).

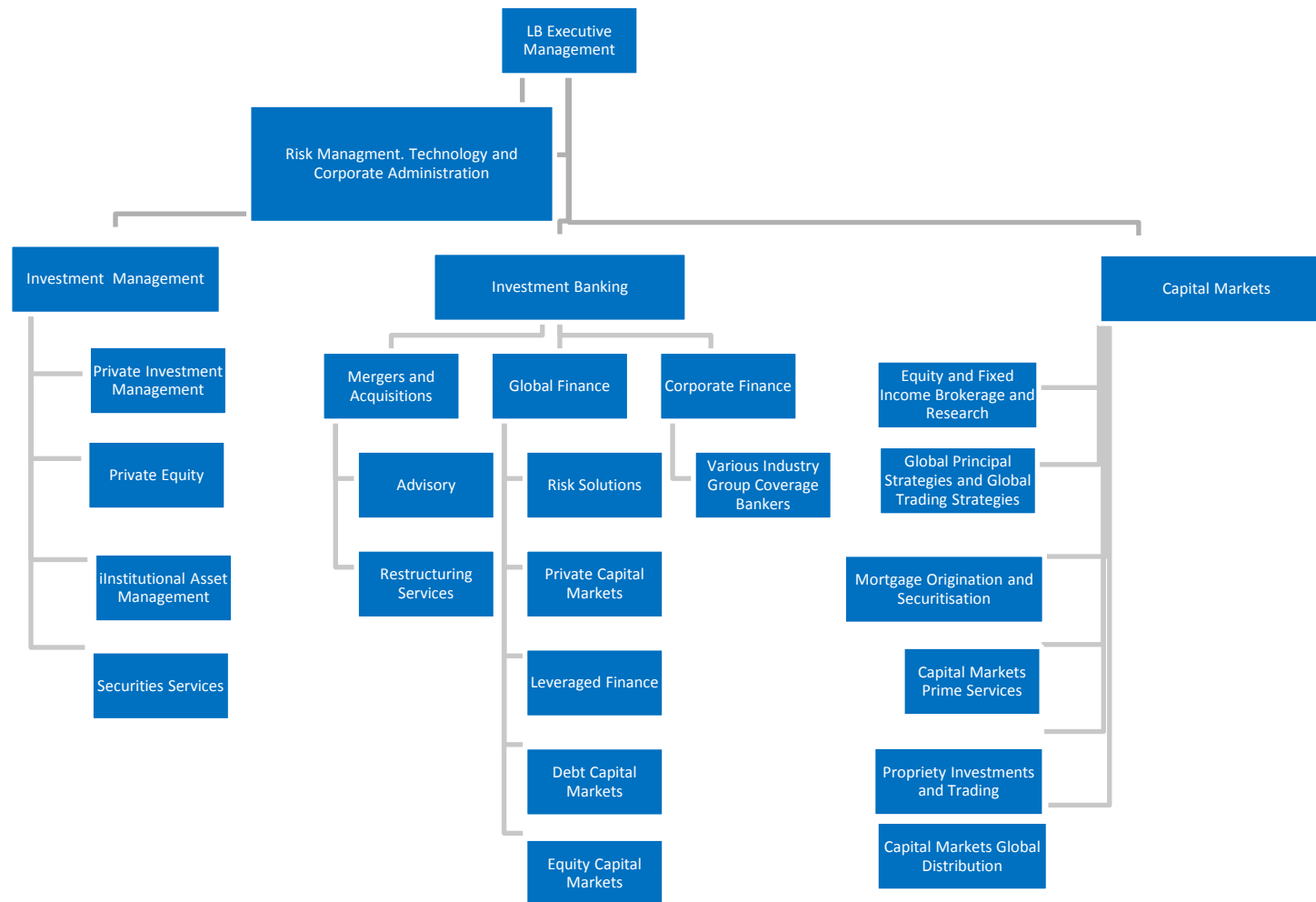
The second major business segment was the Investment Banking Division which comprised: Mergers and Acquisitions (M&A); Global Finance; and Corporate Services departments. The M&A department included the Advisory and Restructuring Services sections. The Advisory section was focused on providing advisory services which supported LB's clients' mergers and acquisitions activities, whilst the Restructuring section assisted corporations in distress to overcome financial difficulties. The Global Finance department generally supported the fund-raising activities of LB's clients. The Risk Solutions section within the Global Finance department identified and managed through their use of derivatives, various risks on behalf

of clients including interest rates, inflation, commodities and currency risks. The Private Capital Markets section assisted clients by raising private equity and financing through the debt markets to optimise their capital structures. The Leverage Finance, Equity Capital Markets, and Debt Capital Markets sections were involved in client fund-raising, often with underwriting commitments. The major risk carried by LB in these sections involved the price risk associated with variations in a securities price (either debt or equity) during the underwriting period. The remaining department within the Investment Banking Division included: the Corporate Finance department which was organised into global industry groups such as the Communications, Consumer/Retail, Financial Institutions, Financial Sponsors, Healthcare, Industrial, Media, Middle Markets, Natural Resources, Power, Real Estate and Technology groups (Lehman Brothers Holdings 2008j, pp. 7-8). These groups incorporated coverage bankers who were experts in their respective industry specialisation and who were the central point of contact to meet the financial objectives of clients (Lehman Brothers Holdings 2008j).

The third major division was known as the Capital Markets Division. Through this division, LB operated a number of departments: the Equity and Fixed Income Brokerage department which offered brokerage and research capabilities to its clients; the Proprietary Investments and Trading department where the firm entered into proprietary securities and derivatives positions, thereby creating risks for its own balance sheet; the Mortgage Origination and Securitisation department which was the department which caused LB's major financial distress prior to its collapse (refer section 6.2 for a discussion of LB's balance sheet problems arising from its CDO warehousing), and where LB accumulated significant volumes of mortgage related assets with the intention of removing them from its balance sheet through the securitisation process. This area relied on the distribution expertise contained in the Capital Markets Global Distribution department which was involved in: the sales of securities in the primary and secondary markets and; the Capital Markets Prime Services department which covered the Secured Financing, Prime Broker, Futures and Clearing and Execution businesses (Lehman Brothers Holdings 2008j, pp. 4-7).

The Capital Markets Division, specifically, the fixed income section of the proprietary investments department is the division where Fuld and most of his senior management team began their careers and developed their trading culture. Refer to Figure 87 for an operational structure of LB. This chart is developed from data obtained from detailed descriptions of LB's activities included as part of its prospectus published for a German bond issue planned in 2008, and therefore represents the last formal comprehensive description of the firm's business activities prior to its bankruptcy.

Figure 87 - Operational Structure of LB



Source: The data used for the chart was extracted from Lehman Brothers Holdings (2008j, pp. 3-10).

LB serviced a full array of clients and their global headquarters was located in New York with other major offices in London and Tokyo. Other satellite offices were positioned in the US, Europe, the Middle East, Latin America and the Asia Pacific region. As a large investment bank, LB was a significant participant and market-maker in all fixed income and equity markets (Lehman Brothers Holdings 2008j, p. 3). LB's public trading activities were conducted through most of the major securities and commodities exchanges of which it was a member. These included the NYSE, and other exchanges in London, Tokyo, Hong Kong, Frankfurt, Paris, Milan, Singapore and Australia. LB also held a membership with the Financial Industry Regulatory Authority – FINRA (Lehman Brothers Holdings 2008j).

As mentioned in section 5.2.6, Russo, LB's Chief Legal Officer, was a member of the Regulatory Policy Committee of the Board of Governors of the Financial Industry Regulatory Authority, which regulates securities firms and US exchange markets on behalf of the NYSE in accordance with SEC requirements. Therefore by having an employee as a member of the policy committee responsible for regulating the activities of the securities industry, LB possessed the potential to influence policy debate relating to its own activities. This enabled an insider to participate in the coercive influence usually found exerted by regulator to the regulated as explained by Milstein et al. (2002) and (Oliver 1990). FINRA is an independent not-for-profit organisation authorised by Congress to protect US investors by ensuring the securities industry: operates fairly and honestly; examines firms for compliance to rules relating to securities dealing; fosters market transparency; educates investors; resolves securities disputes; and deters misconduct by enforcing the rules by either imposing fines, suspending or barring firms from operating in the industry. An examination of Financial Industry Regulatory Authority (2017) database of adjudications and decisions relating to non-compliance of regulations by securities firms which extends back to 1997 revealed no actions against LB.

Apart from its proprietary trading activities, LB conducted business with its clients through a client centric model where a team of coverage bankers maintained relationships with clients based on their industry. This entailed the allocation to clients of industry-expert coverage bankers so that an intimate knowledge of the challenges, opportunities, risks and strengths of the client and its industry could provide helpful insights in providing advisory services and generate fund raising opportunities for LB. Product specialists were called in for assistance as required. LB's strategy was to be a one stop shop for its clients and to diversify its range of activities in an attempt to withstand downturns in the global and domestic economic cycles (Lehman Brothers Holdings 2008j).

7.2.1 Similarities in the Peer Group's Business Model

The large investment banks in LB's peer group included Bear Stearns, Morgan Stanley, Goldman Sachs and JP Morgan Chase. Generally speaking, they adopted very similar busi-

ness models and activities. Although JP Morgan Chase undertook investment banking activities, the majority of its business comprised commercial banking activities. Therefore any balance sheet or profit and loss comparisons within LB's peer group included in this section needs to account for the nature of JP Morgan Chase's different activities and allow for a significant portion of its balance sheet to comprise loan receivables normally associated with commercial banking operations. Operational descriptions of JP Morgan Chase in this section however specifically relate to its investment banking operations.

US Investment banks operate in a competitive and ambiguous environment where economic cycles, and evolving technology and innovation are constant features and challenges. As discussed in section 4.4, firms rely heavily on valuable resources such as capital, reputation, prestige, and skills of employees to deal with the competitive nature of the industry. Firms are challenged to enhance performance, generate future revenue and portray compliance to industry standards and regulation, whether it be voluntary or imposed. Therefore investment banks compete for the abovementioned valuable resources to provide them with any advantage. In order to compete effectively, firms also try to ensure they stay up-to-date on technology and product development. Not offering a similar innovative product suite as those of its competitors may indicate a business has not embraced best practice in its customer service proposition and therefore risks becoming a marketing disadvantage. Mimicking a new product development or customer service strategy of a competitor would reduce this risk (Boxenbaum & Jonsson 2008).

Analysts, on whom stockholders regularly rely for stock selection recommendations, naturally analyse peer group performance as part of their overall assessment of an investment bank. Often included in their assessments, are the access an investment bank has to the abovementioned valuable resources. If an investment bank significantly underperforms relative to its peer group, the underperformance would be reflected in the analyst's recommendation, whose normal practice is to apply a sell recommendation if the underperformance was considered material. This practice, which particularly affects access to capital, places significant pressure on firms to publish accounts showing strong performance. Additionally, according to section 10.5, employees prefer to be associated with a market-leading employer not only because it would impact favourably on their bonuses, but because it would enhance their staff mobility and in turn the potential opportunities of joining another firm on a higher compensation arrangement.

For these reasons, investment banks are motivated to replicate each other's business models in an effort to reduce any comparative peer group underperformance. The process of replication of a business model is explained by DiMaggio & Powell's (1983) mimetic isomorphism. This arm of DiMaggio & Powell's (1983) theory, and supported by Boxenbaum and Jonsson (2008) and Hasse and Krücken (2008), argues that businesses pursue a similarity within their own sector, as this type of conformity draws on the perception that a common

practice is perceived as risk averse. The conformity follows a process of ‘reverse observation’ whereby firms observe each other’s behaviours and practices to identify those that have the potential to minimise the cost of human capital, and enhance prestige and reputation – the major features on which firms compete. The focus on comparing themselves to competitors is evidenced in their annual reports and strategy documents as analysed in section 10.6.1. Furthermore the practice adds legitimacy in the eyes of stakeholders, in this case stockholders and employees.

Although each investment bank named and described each of their operating divisions slightly differently, for example using different business segment titles in their annual reports, this section has summarised their activities into three segments for comparison purposes. The process undertaken involved classifying the various business activities identified in the business segment reporting contained in the Form 10-K⁶⁵ annual reports for each investment bank and categorising them into three broad segments: ‘Wealth Management, Asset Management and Securities Services’; ‘Investment Banking’ and ‘Total Principal Transactions and Trading’ as shown in Figure 88. The categorisation process involved allocating business segments to the broad categories which more closely resembled their activity. The classifications in Figure 88 summarises the segments used and their allocation into three broad categories. The investment banks all offered a similar one stop shop business model focused on providing a comprehensive suite of services to their clients across all investment banking activities. Additionally within each division, there are the administrative areas known as the middle and back offices, which support the revenue raising departments known as the front offices.

Figure 88 - Business Segment Classifications Used in Investment Bank Annual Reports

Business Segment Classification Used in Figure 89	Businesses Descriptions Used in Annual Reports
Wealth Management, Asset Management and Securities Services	Private Client Services Institutional Asset Management Private Equity Account Administration

⁶⁵ Form 10-K reports are the annual financial statements which are lodged with the SEC. They are publicly available and comply with all US accounting standards.

Business Segment Classification Used in Figure 89	Businesses Descriptions Used in Annual Reports
Investment Banking	M&A Fees Underwriting Fees Merchant Banking
Total Principal Transactions and Trading, or Similar	Equity Trading Fixed Income Trading Proprietary Transactions Brokerage Clearing Services Treasury Trading and Services

Figure 89 outlines reported net revenue⁶⁶ attributed to the three broad business segments of each of the five selected peer group investment banks. Data is taken from the segment reporting sections of their annual reports for latest full year reporting period prior to LB's bankruptcy⁶⁷. Businesses excluded from the segment reporting include: retail banking, commercial banking, and card services, all of which related to segments included in JP Morgan Chase's annual report. These segments specifically relate to commercial banking operations which were not carried out by the other members of the peer group.

⁶⁶ Net Revenue is defined as Total Revenue (fees, commissions, revenue from asset sales, interest income, and dividends) less Financial Asset Devaluation and Interest Expense. It is likened to the notion of 'gross profit' as it represents a profit calculated after subtracting from gross revenue, direct input costs, which for a financial institution includes interest expense and devaluations on financial assets held. It is therefore before overheads and tax.

⁶⁷ Merrill Lynch is normally included in the peer group however has been excluded from the peer group comparison as it grouped results in only two segments: Global Markets and Investment Banking; and Global Wealth Management. Therefore a meaningful comparison could not be presented.

Figure 89 - Net Revenue - Investment Bank Peer Group Segment Reporting for 2007/2008

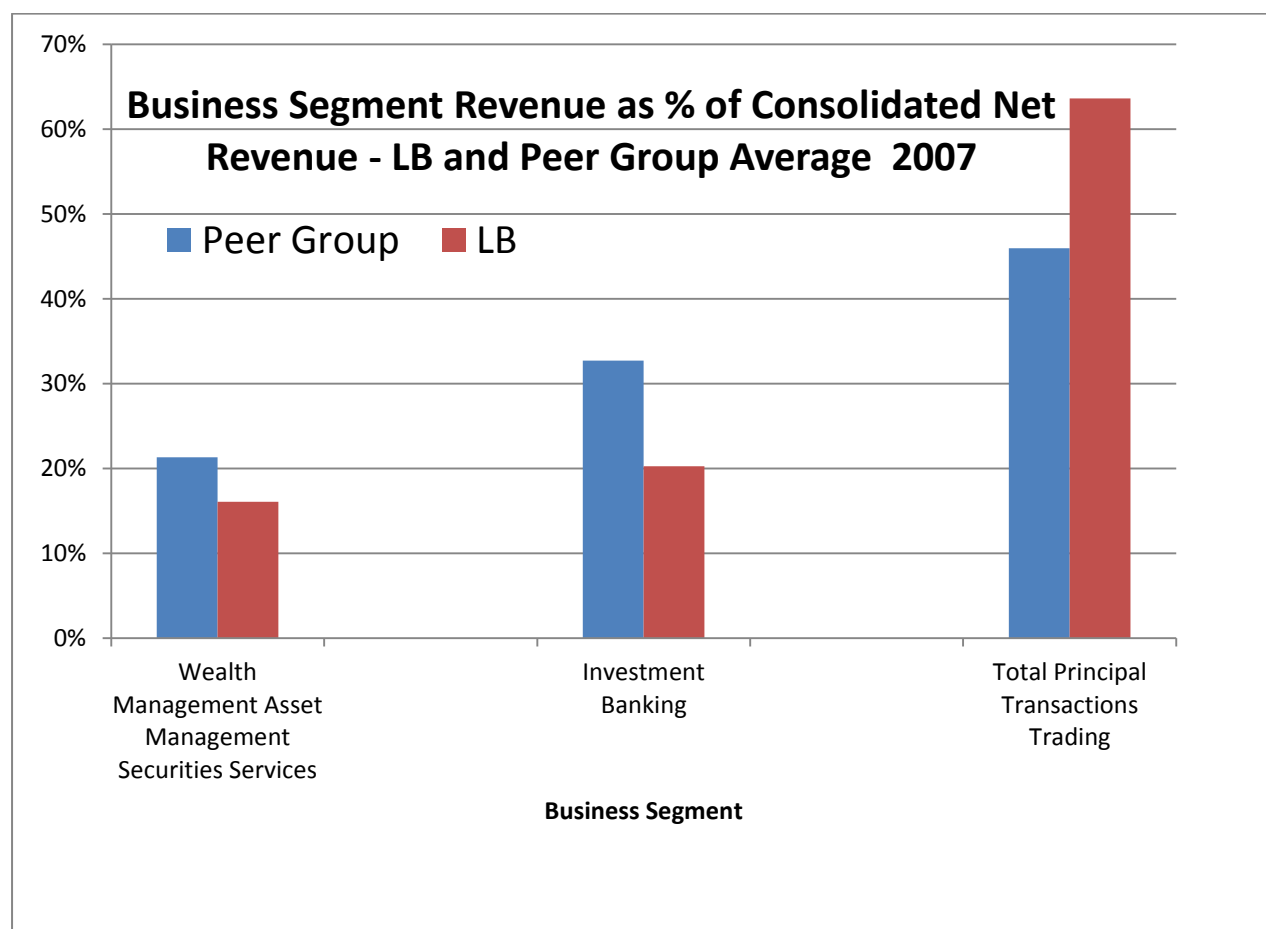
Business Segment	Bear Stearns		Lehman Brothers		Morgan Stanley		Goldman Sachs		JP Morgan²		Industry Average
	USD million		USD million		USD million		USD million		USD million		%
	NR¹		NR		NR		NR		NR		NR
Wealth Management Asset Management Securities Services (or similar)	830		3,097		6,519		7,206		12,880		
% of NR	14		16		27		16		52		34
Investment Banking (or similar)	3,849		3,903		6,368		7,555		13,761		
% of NR	64		20		27		16		36		36
Total Principal Transactions and Trading (or similar)	1,323		12,257		11,150		31,226		11,354		
% of NR	22		64		46		68		12		30
Total Revenue	6,002		19,257		24,037		45,987		37,995		100

Source: Data was extracted from 2007 Form 10-K Annual Reports for each corporation:
(Bear Stearns 2006, p. 109; Goldman Sachs Group 2008a, p. 3; JP Morgan Chase 2007, p. 41;
Lehman Brothers Holdings 2007, p. 47; Morgan Stanley 2008a, p. 49).

Notes:

1. NR = Net Revenue
2. JP Morgan Chase has been included in the comparison even though it had merged with the bank, Chase Manhattan Corporation in 2000, thereby, not officially classified as a non-bank financial institution. However, as it did carry out investment banking activities it is included in the comparisons.

Figure 90 - Average Business Segment Size Based on Consolidated Net Revenue for LB and Peer Group - 2007⁶⁸



Source: Data was extracted from 2007 Form 10-K Annual Reports for each corporation: (Bear Stearns 2006, p. 109; Goldman Sachs Group 2008a, p. 3; JP Morgan Chase 2007, p. 41; Lehman Brothers Holdings 2007, p. 47; Morgan Stanley 2008a, p. 49).

Business segments were common for each investment bank (refer Figure 90) even though the proportion of net revenue generated by each respective segment differs (refer Figure 89). The slightly differing proportions of segment net revenue reflect the subtle differing

⁶⁸ Average was calculated as the simple average of all peer group members for the fiscal year 2007.

strategic objectives of each investment bank at the time. These strategic objectives may also indicate the differing comparative advantages of each firm. For example, LB's traditional strengths in trading and appetite for the risks associated with that activity are reflected in the larger proportion of their net revenue generated by the Total Principal Transactions and Trading Division. Rhee (2010) argues that the business models of investment banks remain stable during prosperous economic cycles. This is explained by the lack of pressure to change strategy due to an ongoing recording of superior returns in such a growth environment. This was the case during the period between 1996 and 2000 when returns on equity for the major investment banks averaged 25% (Rhee 2010, p. 181). Refer section 7.3 below for a peer group financial analysis.

The discussion of the historical context of the economic cycle during the decade prior to the GFC is relevant. A major impetus to growth for the industry arose from The Gramm-Bleach-Bliley Act of 1999, which removed the barriers to cross-selling of investment banking and commercial banking products (Mayer et al. 2009). As a result investment banks could seek banking licences or merge with bank holding companies, and therefore offer a wider range of products and services. However, after the 2001/2002 stock market collapse which was precipitated by the 'Tech Bubble',⁶⁹ and the 11 September 2001 terrorist attack, the consequent drop in overall US investment activity negatively impacted the business segments most susceptible to economic downturns. These included the Wealth Management, Asset Management and Securities Services and Investment Banking segments, whose proportion of the combined industry's net revenue declined. In response, most of the industry diverted its focus towards the Total Principal Transactions and Trading Divisions, which contributed 69% of Net Revenue by 2006 compared to 15% for investment banking and 16% for asset management (Rhee 2010, pp. 81-2). Contributions from the Total Principal Transactions and Trading Divisions in 1997 were much lower - approximately 40% (Rhee 2010, p. 85).

Section 7.3 provides a financial analysis of LB highlighting the escalating on-balance sheet risks during the period 2007 to 2008 and resulting reduction in profitability prior to LB's bankruptcy. The section also presents evidence that the abovementioned mimetic influ-

⁶⁹ The 'Tech Bubble' is a term describing the significant growth in stock prices of corporations involved in the high technology industries which was followed by a sudden crash in that segment's stock prices in 2001.

ences which affected the peer group business models also extended to the financial structure of the other large investment banks.

7.3 Financial Structure Overview

This section presents a financial analysis of LB and the US investment banking industry. It commences with a trend analysis of LB's financial position based on a financial data summary and a time series of financial ratios including balance sheet and performance ratios, to understand the evolution of the firm's risk profile. The time series covers a term of four years concluding in 2007, representing the last full year that audited financial statements were published by LB. This term provides a meaningful period to analyse management's medium term decision-making leading up to 2008. Interim quarterly financial statements for February, May and August 2008 were also analysed to show a continuing deterioration of the firm's financial position in the immediate period prior to bankruptcy on 15 September 2008.

Secondly the financial structure of each investment bank in the peer group for their respective financial year ending in 2007 is analysed to identify the differences between those banks that survived in their own right and those that effectively failed. Finally, a discussion of the mimetic influences affecting the financial structure of the participants in the industry explains why more than one bank effectively failed.

7.3.1 Financial Ratios of LB

This section presents a trend analysis of LB's financial position showing fluctuations in LB's risk profile using selected financial ratios over the four years to 2007.

Figure 91 - Selected Financial Ratios for LB for the Financial Years 2004 to 2007

	Year Ended 30 November			
LB Key Financial Ratios	2004	2005	2006	2007
Current Ratio (Current Assets/Current Liabilities)	0.93x	1.01x	0.99x	0.91x
Liquid Asset Ratio (Liquid Assets/Total Assets)	0.38x	0.41x	0.43x	0.42x
Capital Ratio (Equity/Total Assets) (%)	4.18	4.10	3.81	3.25
Long Term Debt Ratio (Long-term Debt/Total Assets) (%)	14	13	16	18
Debt to Equity (Total Liabilities/Total Equity less Intangible Assets)	29x	29x	31x	36x
Warehoused Mortgages and other investments/Total Assets (%)	10.81	10.69	11.46	12.89
Warehoused Mortgages and other investments/Total Equity (%)	258.69	260.99	300.80	396.20
Return on Equity (Net Profit before taxation / Equity) (%)	23.58	28.75	30.77	26.74
Return on Assets (Net Profit before taxation / Total Assets) (%)	0.98	1.18	1.17	0.87

Source: Ratios calculated from data contained in (Lehman Brothers Holdings 2005a, pp. 71-3; 2007, pp. 85-7).

Figure 92 - Key Financial Data for LB for the Financial Years 2004 to 2007

	Year Ended 30 November			
LB Summary Financial Data	2004	2005	2006	2007
	(USD Millions)	(USD Millions)	(USD Millions)	(USD Millions)
Total Revenue	21,250	32,420	46,709	59,003
Net Profit After Tax (NPAT)	2,297	3,191	3,941	4,125
Net Profit Before Tax (NPBT)	3,518	4,829	5,905	6,013
Total Equity	14,920	16,794	19,191	22,490
Total Assets	357,168	410,063	503,545	691,063
Total Liabilities	342,248	393,269	484,354	668,573
Long Term Borrowings	49,365	53,899	81,178	123,150
Warehoused Mortgages and other Investments	38,597	43,831	57,726	89,106

Source: (Lehman Brothers Holdings 2005a, pp. 71-3; 2007, pp. 85-7).

LB's Balance Sheet Structure – 2004 to 2007

Figure 92 depicts a deteriorating trend of LB's balance sheet structure. The firm's liquidity ratios appear stable up until 2007 however more recent data necessary for an analysis of liquidity ratios in 2008 was not included in the LB quarterly financial reports which provided summary balance sheet data only. CHAPTER 6 however, discusses how a loss of confidence pulled much of LB's liquidity lines and available liquid assets to meet the demands of creditors towards the latter part of 2008, thereby allowing for a reasonable assumption that liquidity ratios would have been impacted.

The critical ratio representing a proxy for the risk profile of LB is the Debt to Equity ratio – an indication of leverage. As shown by Figure 91, this ratio climbed from 29:1 in 2004 to 36:1 in 2007. A commensurate increase in the long term debt ratio shows the increase in leverage was not limited to short term debt as the Long Term Debt ratio climbed from 14% in 2004 to 18% in 2007. Given the trend of increasing long term debt occurred over several years, it indicates a conscious management decision to increase the firm's leverage as part of an overall medium-term strategy. The capital ratio, effectively an inverse of the leverage ratio, exhibits a gradual decrease from 2004 to 2007, again reflecting an increased reliance on debt as opposed to equity in financing the firm's investments. Despite LB's high and increasing leverage it claimed to comply with all capital regulations explicitly in its latest 2007 Form 10-K Annual Report (Lehman Brothers Holdings 2007, p. 134). LB noted the regulatory framework under which it operated as follows:

The SEC has granted us permission to operate under its CSE rule, a voluntary framework for comprehensive, group-wide risk management procedures and consolidated supervision of certain financial services holding companies. The rule allows LBI [broker-dealer subsidiary] to use an alternative method, based on internal models, to calculate net capital charges for market and derivative-related credit risk. Under this rule, Lehman Brothers is subject to group-wide supervision and examination by the SEC and is subject to minimum capital requirements on a consolidated basis consistent with the Basel II Accord published by the Basel Committee on Banking Supervision. The CSE Rules are designed to minimize the duplicative regulatory requirements on U.S. securities firms resulting from the EU Directive (2002/87/EC) concerning the supplementary supervision of financial conglomerates active in the EU. This Directive permits non-EU financial groups that conduct business through regulated financial entities in the EU to demonstrate that they are subject to equivalent consolidated supervision at the ultimate holding company level; the FSA has determined that the SEC undertakes equivalent consolidated supervision for Lehman Brothers (Lehman Brothers Holdings 2007, p. 13).

Certain other subsidiaries are subject to various securities, commodities and banking regulations and capital adequacy requirements promulgated by the regulatory and exchange authorities of the countries in which they operate. At November 30, 2007, these other subsidiar-

ies were in compliance with their applicable local capital adequacy requirements (Lehman Brothers Holdings 2007, p. 134).

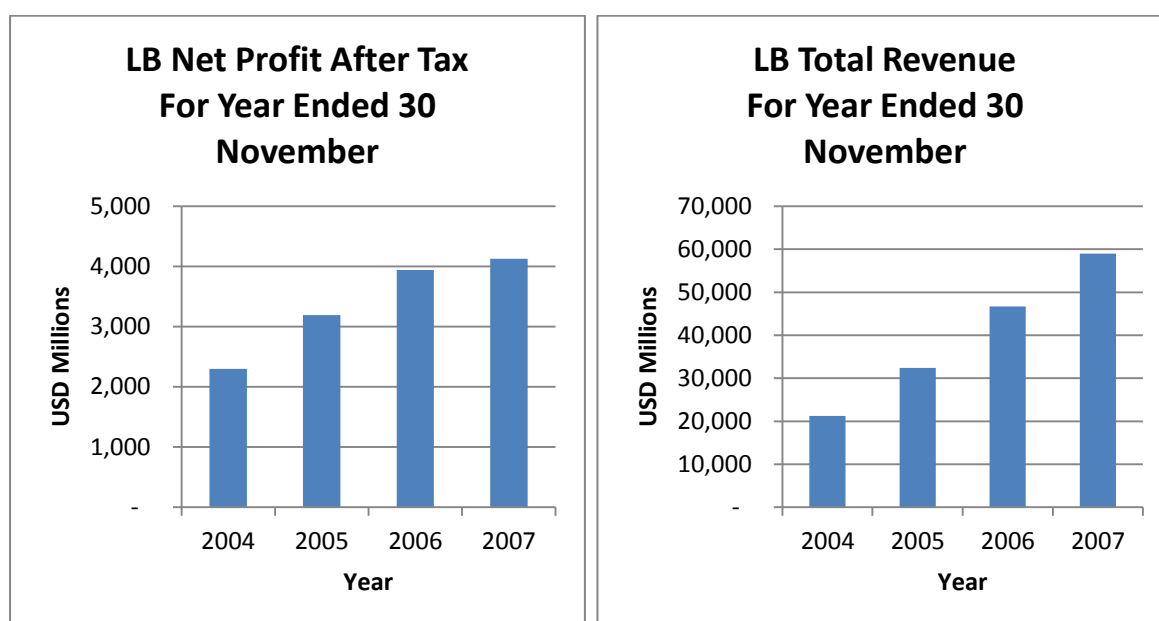
In line with Fuld's strategy of warehousing mortgaged assets and CDOs as discussed in section 6.2.2, the amount of mortgage assets and other investments swelled from USD 38.6 billion in 2004 to USD 89.1 billion in 2007 (Figure 92). As a percentage of total equity, this portfolio of risky assets increased consistently from 259% in 2004 to 396% in 2007. As a percentage of total assets the increase was from 10.8% in 2004 to 12.9% in 2007 - refer to Figure 92. A detailed discussion of the CDO market and LB's exposure to this asset class is included in Section 6.2.

In summary, LB's balance sheet structure weakened over the period 2004 to 2007 as evidenced by an increasing reliance on leverage, and maintaining an asset composition containing an increasing proportion of low quality assets. Section 7.3.10 argues that increasing the risk profile of the balance sheet was a practice that all US investment banks followed from 2003 until 2007, further supporting the notion that they were subjected to a mimetic influence which is discussed below. Section 7.3.10 discusses the financial performance of LB over the same period.

LB's Performance – 2004 to 2007

LB's profitability increased year on year from 2004 to 2007. NPAT increased significantly, rising by 39%, 24%, and 5% for the years to 2005, 2006 and 2007 respectively. This performance was based on increases in total revenue of 53%, 44%, and 26% for the same respective periods. 2007 was a record year for LB in terms of total revenue and NPAT. Refer to Figure 93 for trends of LB's NPAT and total revenue.

Figure 93 - LB NPAT and Total Revenue for Period 2004 – 2007



Source: (Lehman Brothers Holdings 2005a, pp. 71-3; 2007, pp. 85-7).

However the year on year percentage increase in NPAT declined significantly from 2006 to 2007 due predominantly to a decreased contribution from the Fixed Income Division which recorded a decline in net revenue of 29% to USD 6.0 billion in 2007 from USD 8.4 billion in 2006. Division contributions to NPAT however, are not available. This deterioration in performance parallels the weakening of the US residential mortgage market and the associated fall in value of the wider credit derivatives market during 2007. See section 6.2.2 for a detailed discussion of the deterioration during 2007 of these markets.

LB's Interim Results – 2008

An analysis of LB's results for the quarters ending February, May and August 2008 is set out in Figure 94. Results presented are derived from unaudited accounts that were sourced from LB's Form 10-Q Quarterly reports (Lehman Brothers Holdings 2008b, pp. 4-6; 2008c, pp. 3-6; 2008d, p. 10).

Figure 94 - LB Quarterly Financial Data - 2008

	For Quarter Ended		
Summary Financial Data	29-Feb-08	31-May-08	31-Aug-08
	(USD Millions)	(USD Millions)	(USD Millions)
Balance Sheet Structure			
Total Equity	24,832	26,276	28,443
Total Assets	786,033	639,432	600,000
Total Liabilities	761,201	613,156	571,557

	For Quarter Ended		
Summary Financial Data	29-Feb-08	31-May-08	31-Aug-08
	(USD Millions)	(USD Millions)	(USD Millions)
Capital Ratio	3.16%	4.11%	4.74%
Debt to Equity Ratio	31x	23x	20x
Performance			
Net Revenue	3,507	- 668	- 2,903
Net Profit After Tax	465	- 2,873	- 4,090
NPBT	663	- 4,087	- 5,824
ROE	2.67%	(15.55)%	(20.48)%
ROA	0.08%	(0.64)%	(0.97)%
% increase (decrease) in NPAT		(718)%	(242)%
% increase (decrease) in Net Revenue		(119)%	(535)%

Source: (Lehman Brothers Holdings 2008b, pp. 4-6; 2008c, pp. 3-6; 2008d, p. 10).

According to Figure 94, LB's balance sheet structure at first glance exhibits an improvement during 2008. In support of this perceived strengthening, the capital and leverage ratios both improved from 3.16% and 31 times to 4.74% and 21 times respectively from 29 February 2008 to 31 August 2008. The improvements resulted from a combination of several instances of raising capital in the form of debt and equity securities totalling USD 11.5 billion during 2008 (refer discussion below) and a drastic reduction in total assets as shown in Figure 94. However the fund-raising was predominantly in the form of securities which included a redeemable feature in their terms and conditions and therefore could be considered as debt securities. Refer to Figure 95 for details of the securities' classification between debt and equity dependent on redemption criteria. Furthermore, the assets as at the interim reporting dates represented a portfolio whose value was in a continual decline during 2008 as shown in Figure 94.

Although the US investment banking industry was not subject to compulsory capital standards as discussed in section 2.1, it is noteworthy that LB's capital ratios for all three quarters in 2008 which ranged from 3.16% to 4.74% were significantly lower than the minimum capital adequacy ratio guideline of 8% issued by the Basel Committee on Banking Supervision which applied to commercial banks globally at that time (*Review of Regulatory Proposals on Basel Capital and Commercial Real Estate* 2006). This deficiency in capital (as measured against the Basel minimum capital guidelines), occurred despite LB's classification of the whole amount of the new securities issued of USD 11.5 billion as equity (Lehman Brothers Holdings 2008c, pp. 3-6; 2008d, p. 10). Figure 95 describes some key terms of the securities issued. If the security included a redemption requirement or potential for redemption, it is classified as debt in the table below. Otherwise the security is classified as equity. The classification of securities with a potential for redemption include convertible stock. Its classifica-

tion as debt is consistent with a conservative approach which is intended to potentially overstate debt than understate it and therefore offer a worst case scenario.

Figure 95 - LB Securities Issues in 2008

Date of Issue	Amount USD Millions	Nature of Issue	Debt/ Equity	Term of Issue Years
30 April 2008	1,000	Senior Notes	Debt	10
2 May 2008	2,000	Subordinated Notes	Debt	30
2 May 2008	2,500	Senior Notes	Debt	10
12 June 2008	2,000	Convertible Stock	Debt	Potential to convert to equity
12 June 2008	<u>4,000</u>	Common Stock	Equity	Permanent capital
Total Debt	7,500			
Total Equity	<u>4,000</u>			
Total Amount	<u>11,500</u>			

Source: (Federal Deposit Insurance Corporation 2011, p. 2; Valukas 2010, pp. 639-40).

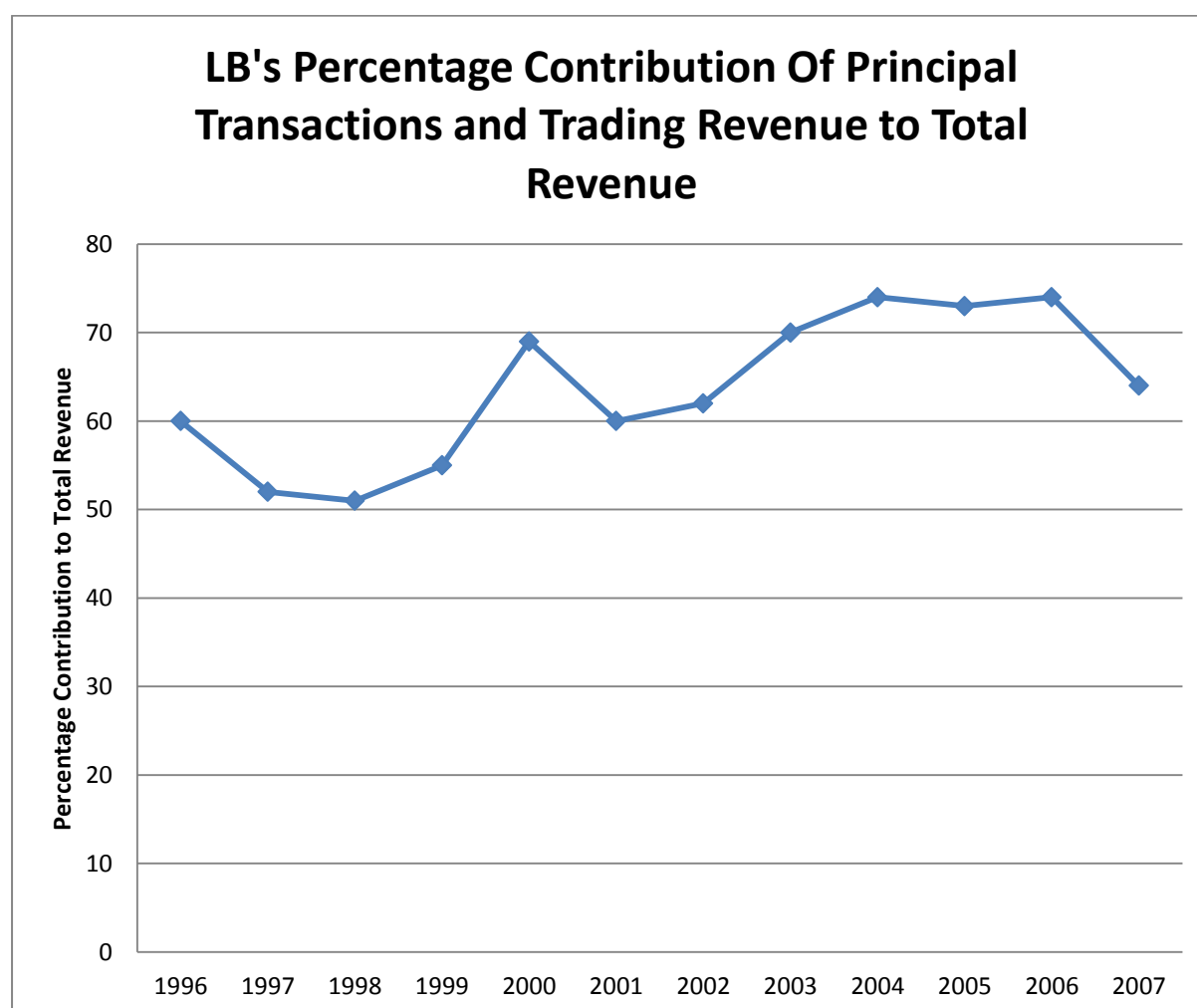
Given the securities issued comprised mostly senior notes, subordinated debt and convertible stock, the permanency of most of this capital is questionable. As issues totalling USD 5.5 billion possessed expiry dates and therefore redeemable at some point in the future, and a further amount of USD 2 billion had only a potential, and not a guarantee of convertibility into equity, they possessed some critical characteristics of debt. That is, the amounts raised were eventually required, or potentially required, to be repaid. A recalculation of the capital ratio by treating USD 7.5 billion as debt whilst retaining the common stock as equity, results in a lower capital ratio of 3.49% instead of 4.74% as at 31 August 2008. Using this revised ratio, LB's leverage shows very little improvement during 2008. These calculations do not include the effect of accounting for Repo 105 transactions as sales as opposed to debt which again would further worsen the capital ratio. Repo 105 transactions are discussed in detail in CHAPTER 9.

The reduction in assets during 2008 was mostly attributable to a sale of liquid assets to meet creditor claims and the devaluation brought about by the implementation of the new accounting standard FAS 157. As discussed in section 6.5, this standard required LB to mark-to-market the firm's financial instruments, which mostly comprised commercial and residential mortgage related assets and CDOs, and to bring to account any related loss to the profit and loss account. The reduction in asset value amounted to USD 7.8 billion comprising USD 5.3 billion in home mortgage assets, USD 1.7 billion in commercial property assets, and USD 800 million of other asset backed instruments and acquisition finance exposures. The trend of devaluations had continued from 2007 and progressed throughout 2008 (Lehman Brothers Holdings 2008b, pp. 4-6; 2008c, pp. 3-6; 2008d, p. 10; Valukas 2010, pp. 203,28,335).

LB's performance in the quarters prior to its bankruptcy deteriorated at an increasing rate with consecutive reductions in ROE and ROA. LB recorded a ROE for the quarter ending 31 August 2008 of negative 20.48%, reflecting a net loss of USD 4.90 billion. The ROE recorded in the previous quarter was a negative 15.55%. These results signified the turning point for investor sentiment towards LB. Therefore, 2008 represented a continuing deterioration of LB's financial structure and downward trend in performance which commenced in 2007.

LB Resorts to Risky Business

Figure 96 - Trend of LB's Principal Transactions and Trading Revenue



Source: The data used for the graph was extracted from Rhee (2010, p. 88).

Figure 96 plots LB's increased reliance on trading activity to generate a larger proportion of total revenues from 2001 until the end of 2006. This activity generated various risks including credit risk, price risk on financial instruments including equities and commodities, foreign exchange risk, and interest rate risk. With increasing volatility in the prices of the underlying instruments which were traded by the trading department, the firm was exposed to

potential losses if positions remained unhedged. Figure 97 outlines measure of volatility for these risks.

Figure 97 - Revenue Volatility of LB's Trading Division

	Trading Division Revenue Volatility		
	Average Revenue Volatility Three Months Ended		
Risk	31-May-08	29-Feb-08	30-Nov-07
	USDm	USDm	USDm
Interest Rate Risk	129	77	58
Equity Price Risk	49	47	41
Foreign Exchange Risk	8	6	6
Commodity Risk	6	5	4
Diversification Benefit	-50	-32	-34
Total Revenue Volatility	142	103	75

Source: (Lehman Brothers Holdings 2008j, p. 33).

The amounts in Figure 97 represent the net revenue volatility of the various trading activities arising over a period of one day for LB. Data for the quarter ending 31 August was not available. The calculations are based on variations around a rolling 250 day mean, measured at a 95% confidence level. The amounts in the table above represent the potential loss to net revenue from trading activities in one day over a 250 day period.

Figure 97 also shows LB's willingness to incur an increasing daily loss level over the 6 month period since 30 November 2007. Trading net revenue volatility measured using this approach amounted to USD 142 million for the three months ended 31 May 2008. This level of volatility represents a 38% increase from the previous quarter ending 29 February 2008, which itself represented an increase over the quarter ending 30 November 2007 of 37%. The period covered above coincides with the mounting asset devaluation problems experienced during 2008. Therefore the increased level of risky trading transactions which were expected to generate commensurate higher returns represents an attempt by LB to offset the losses associated with the valuation problems.

Trading represents a risky activity where large sums can be gained or lost due to small variations in underlying prices or rates. Variations of this magnitude do not normally exist in either the Asset Management or Investment Banking segments of the business, which generate income streams predominantly from fees and commissions (Lehman Brothers Holdings 2008j). It is no surprise therefore, that two of the three banks that technically failed, Morgan Stanley and LB, focused heavily on the risky business of trading as depicted in Figure 89. The following section outlines a comparison of the financial position of LB's peer group drawing some similarities in certain aspects of their balance sheet structures.

Figure 98 - Selected Financial Ratios for Peer Group for the Financial Year Ended in 2007

Ratios	Lehman Brothers	Bear Stearns	Merrill Lynch	Goldman Sachs	Morgan Stanley
Balance Sheet Ratios					
Current Ratio (times)	0.91x	0.98x	0.58x	1.41x	0.8x
Liquid Asset Ratio (times)	0.42x	0.39x	0.30x	0.43x	0.5x
Capital Ratio %	3.25%	2.98%	3.00%	4.47%	2.99%
Long-term Debt Ratio %	18%	15%	20%	15%	15%
Debt to Equity Ratio (times)	36x	35x	37x	24x	32x
Performance Ratios					
ROE (%)	26.74	5.49	-42.88	35.16	8.88
ROA (%)	0.87	0.16	-1.34	1.57	0.27

Source: Data used in calculations was extracted from Form 10-K reports for each corporation (Bear Stearns 2007a, pp. 80-2; Goldman Sachs Group 2007a, pp. 107-10; JP Morgan Chase 2007, pp. 104-5; Lehman Brothers Holdings 2007, p. 29; Morgan Stanley 2007, pp. 101-4).

Mimetic pressure in Financial Structure

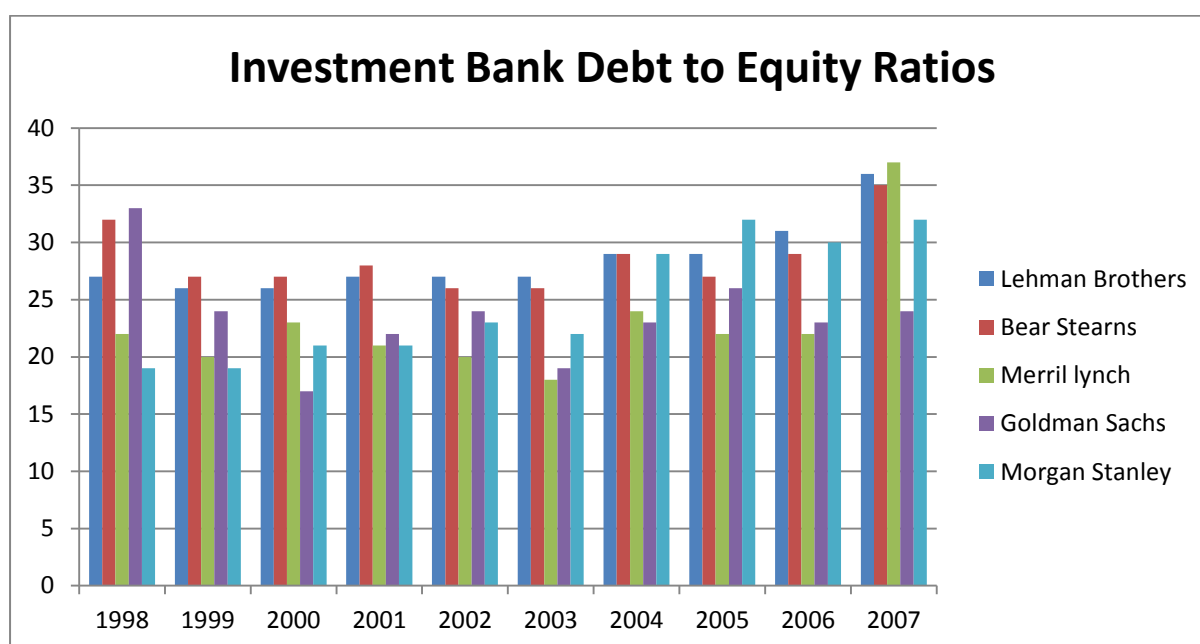
Figure 98 sets out a comparison of key financial indicators for US investment banks for the year ended 2007. This ratio analysis reveals the peer group shared a similar financial structure as most balance sheet ratios lie within a narrow range. The most revealing feature in the financial structures is the common use of high levels of leverage as illustrated in Figure 99. The combination of increased debt and the use of securitisation and credit derivatives was a popular means of maximising profits amongst commercial banks and investment banks alike. The process of using debt to finance additional income generating activities is known as the 'leverage effect'. As the US investment banks realised they could increase profits simply by expanding this cycle of increased borrowings to expand their securitisation

warehouses, portfolios of credit derivatives, and trading activities, their balance sheets and leverage levels swelled along with their levels of profitability.

Important to CEOs was the return on equity measure, which constituted a key metric in their bonus calculations (Bebchuk et al. 2010). Activities which produced a higher margin than the interest expense incurred on additional debt were pursued by all banks. As long as the equity levels remained at least relatively constant (not increased), return on equity would increase. The increase in return on equity encouraged all investment banks to maximise borrowings in the absence of mandatory capital regulations. This mimetic pressure to maximise returns was driven by a common desire to maximise stockholder wealth and CEO compensation. This common approach to maximising revenue at the expense of additional risk was copied throughout the industry and consistent with the mimetic influence described by Galaskiewicz and Wasserman (1989). In turn employees would benefit from the cascading bonus structures and employee satisfaction would be maintained, thereby safeguarding the positions of the firms' leadership.

As investment banks observed from each other that returns could be enhanced from the implementation of the leverage effect, the maximisation of borrowing capacity by each bank was replicated. This is evident in the escalation of leverage by a constant rate for all investment banks from 2003 to 2007. Figure 99 clearly shows the ramping up of leverage since 2003 with LB, Bear Stearns and Merrill Lynch recording the highest increases. The compounding leverage was incurred regardless of the additional risk to the firm that was being incurred. The higher levels of firm risk were justified on the grounds that all other large investment banks were following the same strategy. This mimetic process legitimised the pursuit of the leverage effect in the eyes of other investment banks, regulators and stakeholders.

Figure 99 - US Investment Banks' Leverage Ratios (Debt to Equity)



Source: The data used for the graph was extracted from Bankscope database, (Bankscope 2014).

As well as financial structures, the investment banks shared similar returns. Figure 100 sets out the return on equity for each investment bank. In the 10 years to 2007, all banks generated positive returns except for 2007 when Merrill Lynch recorded a significant loss. The industry average returns on equity during this period (excluding 2007 due to the outlying return recorded by Merrill Lynch) ranged from a low of 14.56% in 2002 to a high of 32.35% in 2000. The lower returns for 2002 were a result of the lower market activity in the aftermath of the 'Tech Bubble' crisis and the September 11 2001 terrorist attack. Refer to Figure 100 for trends in US investment bank returns on equity for the period 1998 to 2007.

More interesting is the narrow band of returns between the members of the peer group. Excluding 2007 and 1998, the standard deviation of returns for the group ranged from a low of 1.26 in 2003 to a high of 9.10 in 1999. This range of returns supports the notion that the firms pursued a similar level of returns and attempted to replicate each other's operations. As discussed in section 7.2.1, the investment banks were motivated to reduce any comparative peer group underperformance to prevent backlash from stockholders and employees and therefore attempted to mimic each other's activities.

Figure 100 - Return on Equity of Investment Banks 1998 to 2007

Investment Bank	Return on Equity %									
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007

Lehman Brothers	19.43	23.92	29.20	18.45	11.68	17.01	23.42	28.75	31.01	26.74
Bear Stearns	19.43	23.92	29.20	18.45	11.68	17.01	23.42	28.75	31.01	5.49
Merrill Lynch	15.49	25.01	26.27	6.36	12.31	17.03	18.06	20.31	26.71	-42.88
Goldman Sachs	45.76	19.64	33.88	20.27	17.12	19.40	24.83	26.54	35.91	35.16
Morgan Stanley	26.63	42.94	43.19	25.44	20.00	19.23	22.19	25.37	31.62	8.88
Peer Group Mean Return	25.35	27.09	32.35	17.79	14.56	17.94	22.38	25.94	31.25	6.68
Peer Group Standard Deviation of Returns	12.10	9.10	6.65	7.00	3.80	1.26	2.59	3.47	3.26	30.31

Source: The data used for the calculations was extracted from Bankscope database, (Bankscope 2014).

According to the key ratios, Goldman Sachs is the standout investment bank with the lowest debt to equity ratio and highest capital ratio, indicating a relative position of strength. Morgan Stanley follows with the second lowest debt to equity ratio. Similarly, Goldman Sachs and Morgan Stanley recorded the highest liquid asset ratio of the peer group. These two banks were the only members of the peer group that survived the GFC even though survival was predicated by major investments from 'White Knights'⁷⁰ and government funding. Therefore it could be argued that the mimetic pressure which affected the rest of the peer group had a relatively lower impact on the surviving investment banks. The investment banks that failed comprised: Bear Stearns, which was forced to merge with JP Morgan Chase; Merrill Lynch & Co., which was sold to Bank of America Corp. and, LB which entered bankruptcy. The undoing of LB together with the other failed investment banks related to their exploitation of the 'leverage effect'. The many years of pursuing a risky growth agenda was crystallised in the last days of LB as creditors and investors awoke to the strategy and

⁷⁰ A white knight, usually a corporation in a strong financial position, is a potential "saviour" of a corporation during either a hostile takeover or in a situation when a distressed corporation requires financial assistance.

punished the firm by selling its shares and recalling credit lines. Refer CHAPTER 6 for a detailed discussion on the last days of LB. The ratio analysis provided above, provides evidence that measures of leverage and liquidity were key determinants of investment bank failure. As such, questions relating to the prevailing lack of a mandatory regulatory constraint on leverage and liquidity arose in the aftermath of the GFC and have since been considered a major weakness of the regulatory framework at the time.

7.4 Summary

This chapter examines the business model adopted by the US investment banks and provided an overview of the financial structure of LB which was compared to its peer group. The investment banking business model is analysed through the lens of DiMaggio & Powell's (1983) New Institutional Theory and found to be subject to a mimetic influence which led to divisional units undertaking similar lines of business. US Investment banks operate in a competitive and ambiguous environment where economic cycles, evolving technology and innovation are constant features and challenges. In their efforts to compete for valuable resources such as capital, reputation, prestige, skills and gain new customers, they attempted to avoid a negative perception associated with an underperforming firm. This strong desire not to be perceived as a low ranking firm spawned a practice of replicating product and services offered by competitors, which resulted in similar divisional organisational structures between firms. An outdated product suite or service offering could have exposed a firm that had not embraced innovation and best practice, important features for an industry in a rapidly evolving environment. Mimicking competitor practices and business models therefore reduced the risk of portraying a negative perception to the market. Submission to mimetic influence often occurs when the correct course of action is ambiguous. The fast paced business environment created the need for urgent management decisions which would avoid criticism if they replicated those of successful firms. Time was critical as any delay in the launching of a new product or service could impact negatively on market share. In this environment, mimicking behaviour of another firm perceived to be successful was time and cost efficient.

In LB's attempt to pursue an aggressive growth strategy, it departed slightly from conforming to the standard business model by expanding the activities of its Trading Department which represented the riskiest part of the firm. This strategy was undertaken in the expectation that the additional risk would generate commensurate high returns in an attempt to mitigate the effects of other divisional underperformance. Fuld's hubris associated with a denial that the economic cycle would turn downward and an optimistic view that the value of financial assets would continue to increase was a belief which continued through the

decade preceding LB's bankruptcy. The combination of increased debt and the use of securitisation and credit derivatives was a popular means of maximising profits amongst all investment banks. This common approach to exploiting the leverage effect is reflected in a range of similar returns generated by the peer group. Fuld's strategies were validated by the similar strategies adopted by most of the peer group and reinforced the hubris which characterised his leadership. Higher leverage was pursued regardless of the risk impact on the firm. As long as LB's creditors abstained from recalling credit, the strategy was sustainable. Those banks which replicated the aggressive leverage effect strategy suffered a similar fate. Succumbing to a mimetic influence was supposed to replicate the practices of firms that were successful, but instead led to disastrous consequences for most of the investment banking peer group. The exceptions - Goldman Sachs and Morgan Stanley, maintained more moderate levels of leverage and higher levels of liquidity. Despite the potential opportunity cost of pursuing a less risky strategy, these banks survived. The following chapter relates the role that connections and influential forces assisted the industry to maintain conditions conducive to their objectives. The chapter therefore examines the relationships between the investment banking industry and other players that had an impact on their business such as regulators, politicians, standard setters and credit rating agencies.

CHAPTER 8 **CONNECTIONS AND INFLUENCE**

8.1 Introduction

The previous chapter described the investment banking model as one influenced by institutional forces, steering the firms to mimic each other in various ways from organisational to financial structures. The major investment banks' organisational structures converged to operate in similarly structured business units, which in aggregate, served as one stop shops for customers. The competitive environment where the desire to be ranked at the top of

league tables⁷¹ for each specialisation, and the need to be perceived as one of the best investment banks to the outside world including customers, shareholders and regulators, created a fear of underperformance. The aspiration to extend financial performance year on year also fuelled the pursuit of the leverage effect which resulted in unsustainable levels of debt for most firms. The theme of DiMaggio & Powell's (1983) institutional influence of the previous chapter as it affected the business model and financial structure of the US investment banks continues to be explored in this chapter. New Institutional theory assists with our understanding of how investment banks co-opted legislators, regulators, CRAs and accounting standard setters, in accepting a stance extolled by the investment banking industry. The liberal stance created a business environment relatively free of obstacles and conducive to aspirations of producing ever-increasing profits.

This chapter commences with an identification of the participants in the 'financial network' which is outlined in section 8.2. The sections that follow discuss the influences applied to the political process and regulatory framework by the use of political contributions and lobbying which produced a type of 'regulatory capture'. Political contributions are argued to have resulted in coercive pressure being applied to the politicians involved in the legislative process to produce the regulatory outcomes desired by the industry. The environment which allowed the application of coercive pressure through political contributions was also constructed by the investment banking industry as a quid pro quo for fulfilling the need by politicians to be seen as wise decision-makers, thereby creating an aura of legitimacy. Repetitive contributions to the same politicians would be interpreted as legitimising their decision-making which was important for election and re-election prospects.

Further section 8.2 asserts that mimetic pressure fuelled the industry's attempts to influence the political process by its common use of lobbying. The unified behaviour of participants in the investment banking industry follows a mimetic pressure to adopt the practice of lobbying, which in turn supported the normative influence of spreading an acceptance of

⁷¹ League tables are published tables ranking investment banks by deal number, revenue, or other market share indicator. As well as ranking overall investment banks, they are used to rank particular divisions such as the mergers and acquisition or capital markets divisions. League tables are published in a variety of media including industry journals, financial market websites such as Reuters and Bloomberg and often appear in the financial press.

the 'laissez-faire' attitude towards regulation. The benefits of a united front, using a combination of influential industry associations, established lobbyists and their own firms' resources, led to an intensive attempt to sway political opinion in favour of the industry. Section 8.2 further asserts that normative pressure was applied to align beliefs and values between the investment banking industry and the regulatory and legislative communities through the 'revolving door' practice. This practice involving professionals switching positions between different employers such as investment banks, regulatory agencies and the executive branch of government was found to be common practice. The consequent intermingling of values and beliefs between various 'revolving door' participants, tended to permeate a popular view that a 'light touch' to regulation was good for the investment banking industry.

Lobbying by the industry is argued in section 8.2 also to be a normative practice, accepted as a norm by the users of lobbyists, the recipients of the lobbying efforts and the public at large who accept it as a legitimate way of persuading points of view in public policy debate. Therefore politicians allowed themselves to accommodate the opinions of industry in their deliberations of bills related to the finance industry. The existence of a knowledge asymmetry between the investment banking industry and the regulators also exerted a normative pressure on regulators to allow a general 'laissez faire' approach to regulating the industry. In the absence of superior knowledge of the complex and innovative derivative products, financial structures and their resultant risks, the regulatory community presupposed that the investment banking industry 'knew best' and would therefore self-regulate.

The modus operandi of the CRAs and the coercive pressure to which they were subjected by the investment banking industry are discussed in section 8.3. This section finds that the investment banking industry's commercial support of the CRAs and their direct input to the credit rating models, helped to drive an increasing number of investment grade ratings for borrowing vehicles which then ultimately failed. As discussed in section 8.3.2, the influence exerted over CRAs to supply investment grade ratings, which were later discovered to be flawed, was also inadvertently supported by the regulatory framework at the time.

Section 8.4 concludes the chapter with a content analysis of comment letters submitted to the FASB regarding two important draft exposures for accounting standards – FAS 125 and FAS 140, which were to apply to the important financing technique known as Repos. This analysis finds the investment banking industry, as a concerned interest group, were intent on retaining their ability to interpret, at their discretion, the applicable accounting standards. The resulting institutional influence over the FASB produced a final standard, FAS 140 which permitted the 'window dressing' of LB's financial statements, thereby concealing important information from stakeholders. LB's process of 'window dressing' is discussed in greater detail in CHAPTER 9.

8.2 The US Financial Network

The major participants within the frame termed the ‘financial network’ include: the investment banking industry; other financial institutions (such as hedge funds, commercial banks, money market corporations and other financial institutions); the regulators; the government (including individual politicians); CRAs; and lobby groups representing the investment banking industry. This section examines how the investment banking industry through their connections and interactions with the ‘financial network’ attempted to influence policies, regulations and credit ratings. Influence over regulations through a ‘regulatory capture’ was particularly important to the industry to ensure a regulatory framework which was conducive to generating stronger financial performance. The notion of regulatory capture is further explained in section 8.2.2.

The prosperous years enjoyed by the investment banking industry prior to the GFC coincided with a period when regulations, accounting standards and the approach to credit ratings minimised constraints on the industry. The theme of ‘connections’ is used in this chapter to identify and analyse the interactions of the investment banking industry with the ‘financial network’. The liberal conditions created through the legislature are detailed in CHAPTER 2. This chapter discusses the enactment of key legislation which encouraged lending and home ownership. The most significant legislation included: The Community Reinvestment Act 1977; The Alternative Mortgage Transactions Parity Act 1982; and the Community Reinvestment Act 1995 (amended) also known as the Community Reinvestment Expansion Act 1995. The Gramm Leach Bliley Act 1999, which is also considered an important milestone in the legislative timeline, offered opportunities for the investment banking industry to expand into other areas such as direct lending. This Act repealed The Glass-Steagall Act, which came into force following the Great Depression of the 1930s and prevented commercial banks, investment banks, securities firms and insurance companies from merging. The final important liberal legislation affecting the investment banking industry prior to 2008 included The Commodity Futures Modernization Act 2000 which excluded derivatives from regulation, supervision, trading on exchanges and most significantly exempted these instruments from capital adequacy requirements. Therefore it provided an unrestricted environment for US investment banks to pursue derivative transactions such as CDOs which, as discussed in section 6.2 played an important role in the lead up to the GFC.

Following the corporate scandals of Enron and WorldCom as outlined in section 4.4.6, the previous liberal approach to regulation was largely reversed with the enactment of the Sarbanes Oxley Act of 2002 which is discussed in section 10.2.2. However, shortly thereafter, political pressure to generally support financial institutions during the period spanning 2001 to 2009 was led by President George W. Bush who encouraged the adoption of neo-liberal principles. This period of political support together with an era of low interest rates

overseen by the Federal Reserve at the time, coincided with a cycle where US house prices and lending increased significantly and created the housing bubble. This would eventually initiate a series of asset write-downs for financial institutions generally - See section 2.2 for a discussion.

In a speech at the Risk Management Association Conference in Oct 2008 Randall Kroszner, who was a member of the Board of Governors of the Federal Reserve and Chairman of its Committee on Supervision and Regulation of Banking Institutions at the time, acknowledged the interconnectedness of the banking industry and financial markets as contributing to the severity of the GFC and the collapse of LB:

At the heart of that transformation lays a much more intense emphasis on funding and liquidity. Additionally, we are all witnessing the extent to which banking and financial markets are interconnected (Kroszner 2008).

Kroszner (2008) was referring to the interconnectedness of financial institutions operating in the financial markets. The GFC highlighted the importance of the role of financial institutional networks in providing liquidity within the market. Many liquidity lines provided on an interbank basis, and on which the banks relied for their day to day business, froze during the crisis period. Kroszner (2008) suggests these financial networks have far-reaching ramifications for the financial markets and the economy. He argues this aspect of the industry needs to be tackled so that appropriate risk management frameworks are established in the global marketplace.

As shown in CHAPTER 4, historically strong personal and institutional networks were considered beneficial in the investment banking industry. However Kroszner (2008) highlights the dangers of a global marketplace entrenched in a convoluted web of connections:

Since banking and financial markets are so interconnected, the fundamental transformation in financial services is affecting all types of financial institutions, even those less directly affected by recent events. Importantly, in developing strategic risk management frameworks, institutions must not only understand the direct consequences to their own firms of such shifts, but must also recognize that consequences to other firms can have effects on the broader market (Kroszner 2008, p. 6).

A diagram representing the interrelationships of the 'financial network' is shown in Figure 101.

Figure 101 - The Interrelationships within the US Financial Network

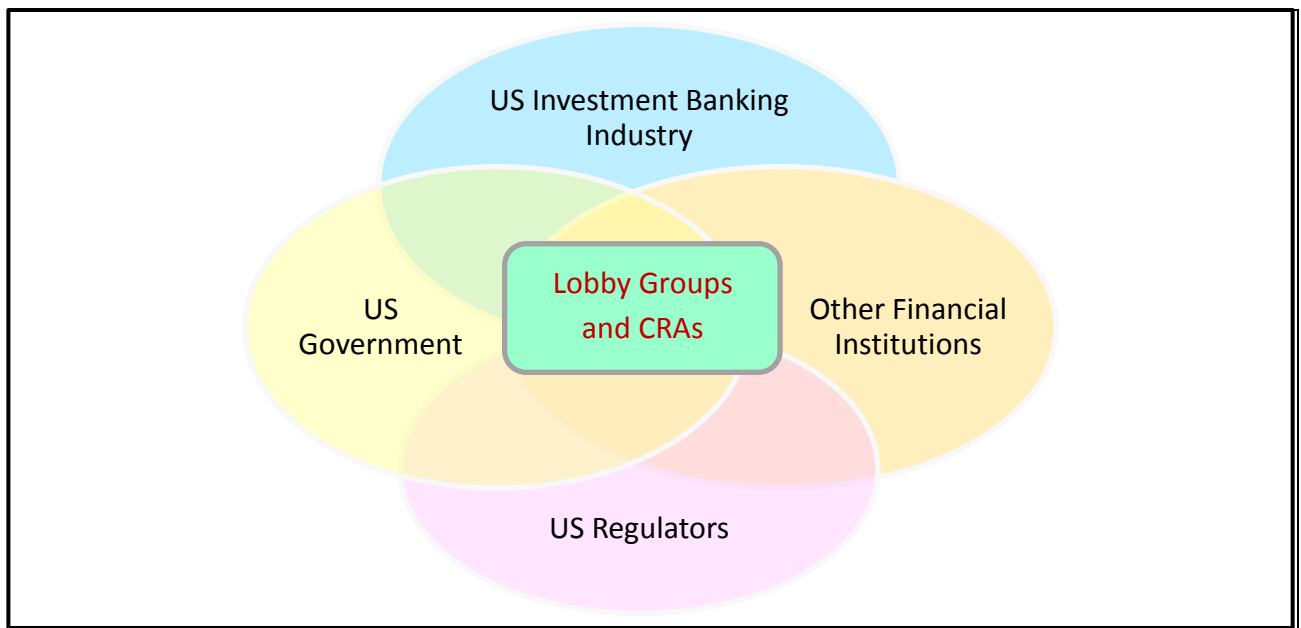


Figure 101 represents the intersecting relationships between various groups in the financial network. The principal lobby groups which represented the investment banking industry included the various industry associations such as: the Securities Industry Association which merged with the Bond Market Association to form the Securities Industry and Financial Markets Association in 2006; the Investment Company Institute; the Security Traders Association; the American Bankers Association; and, the International Swaps & Derivatives Association. A specific industry lobby group based in Washington known as The Financial Services Roundtable (FSR), formerly known as the Bankers Roundtable prior to 2000, had access to all participants in the 'financial network' and played an active role as an institutional force (Froomkin & Blumenthal 2012). The CRAs were also central to the relationships between participants as their credit ratings were relied upon by investors, regulators and issuers (and their sponsoring/underwriting investment banks). The largest credit rating agencies were Standard & Poor's (S&P), Moody's, and Fitch. All three are privately owned corporations and whilst S&P and Moody's are both US-based corporations, Fitch operates from both the US and the UK. Their influence originates from their role in collectively assigning credit ratings to over 90% of global corporations, governments (including state governments), state owned enterprises, and structured finance SPV's (Coffee et al. 2010, p. 1). These ratings have an influence on the demand for securities as they are purported to be a measure of the issuer's financial strength. Furthermore, the pricing of securities is generally aligned to the ratings, rewarding stronger rated issuers with lower pricing on their financing transactions (Coffee 2011). Methodologies employed by CRAs in determining a credit rating are therefore considered to be an important component of their intellectual capital. The resultant ratings are also important to government and regulators who want to ensure that inves-

tors and the market are well informed. A background of the CRAs, including the influence on their rating methodology is provided in section 8.3.

The principal regulators within the ‘financial network’ include the Federal Reserve and the Securities Exchange Commission. Other regulators include the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and Federal Financial Institution Examination Council. The following sections discuss the types of influence and the conduits through which such influence was exerted by the investment banking industry on the members of the ‘financial network’. The discussion commences with the role that political contributions played in the creation of a liberal attitude towards the regulatory framework within which the investment banking industry operated.

8.2.1 Political Contributions

Politicians require funding to contest their first election as well as for re-election. A seat in the House of Congress costs an average of approximately USD 1 million, and Senate seats often require funding of tens of millions (Senate Office of Public Records Government of the USA 2011). The cost of running the 2016 US Federal election for example is shown in Figure 102.

Figure 102 - Cost of Running the US Federal Election in the 2016 Election Cycle as represented by Total Contributions

Type of Group	Total Spent USD	% of Total
Super Political Action Committees (Super PACs)	1,104,481,088	66%
Political Parties	246,159,843	15%
Social Welfare Groups	147,333,276	9%
Other (corporations, individual people, other groups)	128,863,700	8%
Trade Associations	33,912,224	2%
Unions	21,621,827	1%
Total	1,682,371,958	100%

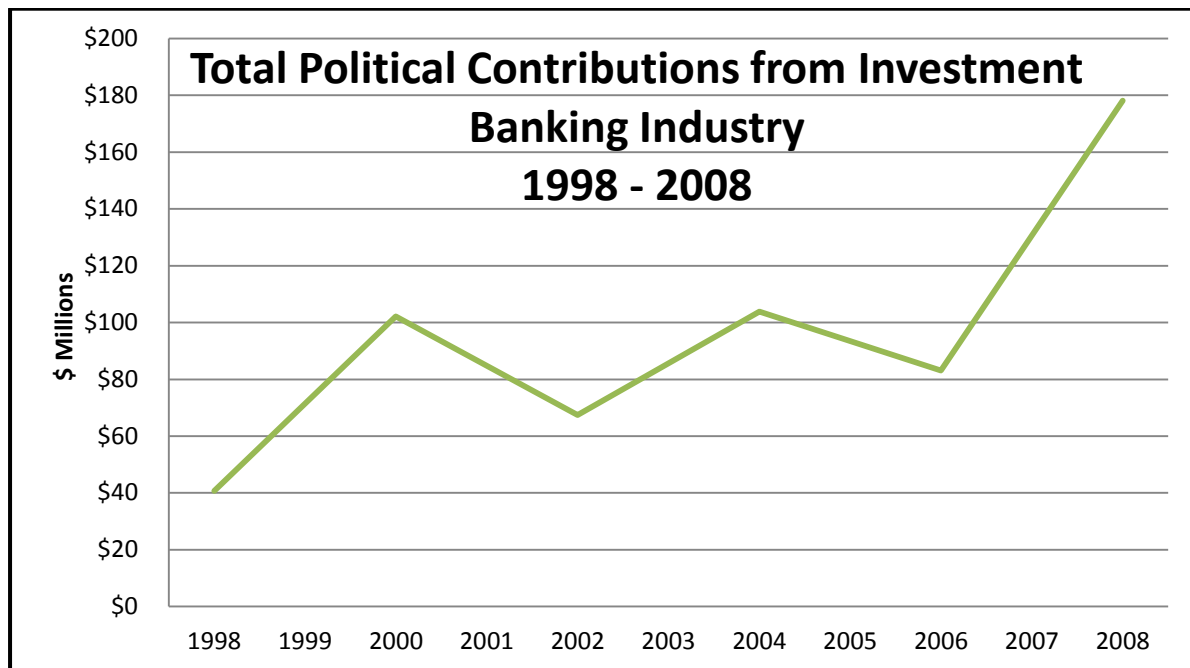
Source: The data used for the table was extracted from Centre for Responsible Politics (2008).

Campaign contributions to a politician may oblige the recipient to support the contributor by either support for its regulatory agenda, friendly political appointments, lucrative government procurement contracts, or tax concessions (Centre for Responsible Politics 2017). In the US, statistics relating to political contributions and industries' lobbying expenditures are collected by an independent organisation known as the Centre for Responsive Politics (CFRP)⁷² which began recording data in 1974. The CFRP is funded by individual contributions and institutional grants. Major donors contributing over USD 100,000 each in 2016 included: Carnegie Corporation of New York, Ford Foundation, William and Flora Hewlett Foundation, John S. and James L. Knight Foundation, John D. and Catherine T. MacArthur Foundation, and the Open Society Foundation (Centre for Responsible Politics 2017). Statistics used in the following figures 102 to 108 and 110 to 117 are sourced from the CFRP database. Amounts included in the statistics represent the historic value of USD dollars and do not represent constant dollars adjusted for the time value of money.

Figure 103 shows a growth in political contributions made by the investment banking industry from 1998 to 2008 representing the 10 year period prior to the GFC, and which reached a peak of USD 178 million in the calendar year 2008. A calculation of the data supplied by CFRP reveals aggregate contributions by the investment banking industry for the period 1998 to 2008 exceeded USD 575 million (Centre for Responsible Politics 2008). LB's political contribution to George W. Bush's 2004 election campaign is detailed in Figure 108. Additionally, evidence of LB's political lobbying spending is shown in Figure 111.

⁷² The Centre for Responsive Politics is a not-for-profit, independent, US organisation which follows the trail of political contributions and their impact on election outcomes and public policy. The organisation's aim is to foster a more transparent government.

Figure 103 - Total Political Contributions from Investment Banking Industry 1998 – 2008



Source: The data used for the graph was extracted from Centre for Responsible Politics database, (Centre for Responsible Politics 2008).

The top 10 recipients of these contributions are included in Figure 104, which also includes each politician's special roles within government and private industry. The roles have been split between those that are finance related and those that are not. In some instances, politicians held roles in consulting firms and/or financial institutions. This is provided to establish those donor recipients who may have a closer relationship with the 'financial network'. Prior to the GFC, the preferred party for contributions from the investment banking industry was often the incumbent majority party, swinging between the democrats and republicans as leadership in Congress switched. This pattern of supporting influential politicians is a cornerstone of the US political system (Centre for Responsible Politics 2008).

Figure 104 - Top 10 Recipients of Campaign Contributions 1998 - 2008

Name D=Democrate R=Republican State	USD Political Contributions from Investment Banking Industry 1998 to 2008	Special Government Roles (not related to Financial Services)	Special Government and Private Roles (related to Financial Services)
Sen. John McCain (R-Ariz)	14,562,427	Chairman of the Senate Commerce Committee, Presidential Candidate 2000, Sponsor of the McCain-Feingold Act in 2002, Chairman of the Senate Armed Services Committee, Chairman of the Senate Indian Affairs Committee	
Sen. Charles E. Schumer (D-NY)	10,543,147	Chairman of the Senate Rules Committee, Chairman of the Democratic Senatorial Campaign Committee, Vice Chairman of the Democratic Caucus, Joint Committee on the Library, Vice Chairman, Joint Committee on Printing, International Narcotics Control Caucus, Select Committee on Intelligence	Member Financial Services Committee and Banking Committee
Sen. John Kerry (D-Mass)	8,178,389	US Secretary of State, Chairman of the Senate Foreign Relations Committee, Presidential Candidate 2004	
Sen. Chris Dodd (D-Conn)	7,961,570	Chairman of the Democratic National Committee, , Chairman of the Senate Committee on Rules and Administration, Committee on Foreign Relations, Joint Committee on the Library, Commission on Security and Cooperation in Europe	Chairman of Committee on Banking, Housing, and Urban Affairs from 2007–2011, Subcommittee on Securities, Insurance, and Investment

Name D=Democrate R=Republican State	USD Political Contributions from Investment Banking Industry 1998 to 2008	Special Government Roles (not related to Financial Services)	Special Government and Private Roles (related to Financial Services)
Sen. Joe Lieberman (I-Conn)	4,775,168	Attorney General of Connecticut, Chairman of the Senate Committee on Homeland Security and Governmental Affairs, Committee on Armed Services, Committee on Small Business and Entrepreneurship	
Sen. Richard C. Shelby (R-Ala)	3,384,175	Chairman of the Senate Intelligence Committee, Senate Committee on Appropriations, Senate Committee on Rules and Administration	Chairman of Senate Committee on Banking, Housing & Urban Affairs from 2003–2007 and 2015-2017
Rep. John Boehner (R-Ohio)	3,334,661	Speaker of the US House of Representatives, House Minority Leader, House Majority Leader, Chairman of the House Education Committee	
Sen. Evan Bayh (D-Ind)	3,224,911	Committee on Armed Services, Committee on Energy and Natural Resources, Committee on Small Business and Entrepreneurship, Select Committee on Intelligence	Committee on Banking, Housing, and Urban Affairs, Subcommittee on Financial Institutions, Subcommittee on Securities, Insurance, and InvestmentSenior adviser Apollo Global Management (Asset management), Partner at Law and lobbying firm McGuire-Woods, Adviser US Chamber of Commerce

Name D=Democrate R=Republican State	USD Political Contributions from Investment Banking Industry 1998 to 2008	Special Government Roles (not related to Financial Services)	Special Government and Private Roles (related to Financial Services)
Rep. Eric Cantor (R-Va)	3,181,842	House Majority Leader, House Republican Chief Deputy Whip, Chairman of the Congressional Task Force on Terrorism and Unconventional Warfare, House International Relations Committee and the House Ways and Means Committee	House Financial Services Committee, Vice Chairman of investment bank Moelis & Company
Sen. Mitch McConnell (R-Ky)	2,818,657	Majority and minority Leader of the Senate, Senate, Senate Majority Whip, Committee on Agriculture, Nutrition, and Forestry, Committee on Appropriations, Committee on Rules and Administration, Select Committee on Intelligence.	

Note: D = Democrat; R = Republican; I = Independent

Source: The data used for the table was extracted from Centre for Responsible Politics (2008).

A number of the top 10 donor recipients had close relationships with the financial network. An example of some of the political views held by some of the top 10 donor recipients is set out in Figure 105.

Figure 105 - Political Views of Selected US Recipients of Large Political Donations

Name (party/state)	Political View	Reference
Sen. Charles E. Schumer (D-New York)	In favour of bailouts for US investment banks.	(Lipton 2008)
	A proponent of a deregulatory agenda for the banking industry. In particular led initiatives to deregulate derivatives and to lower capital reserves for the banking industry.	
	Supported tax savings for financial institutions.	

Name (party/state)	Political View	Reference
	Attempted to limit efforts to regulate CRAs in favour of self-regulation.	
	Advocated revisions to regulations intended to improve transparency of corporate financial statements.	
	Opposed a bill that proposed to increase personal income taxes for executives at hedge funds and private equity firms.	
Sen. Richard C. Shelby (R-Alabama)	Prioritised regulatory relief for the finance industry.	(Flaherty 2015)
	Objected to the Government Office of Financial Research collecting financial data necessary to regulate the banking industry.	(Cover 2010)
Rep. John Boehner (R-Ohio)	Maintained close relationships with lobbyists and former employees representing large corporations such as Goldman Sachs, Google, Citigroup, R.J. Reynolds, Miller Coors and UPS. Was in favour of light regulations on the financial services and tobacco industries.	(Lipton 2010)

Political Contributions during the 2004 Election Cycle

The 2004 election cycle was the last before the onset of the GFC. The period between 2004 and the next election cycle in 2008 represented a period of significant profitability for the investment banking industry, which thrived under positive economic conditions. See section 6.6.2 and Figure 100 for a depiction of the economic environment and the positive returns on equity of the US investment banks respectively during this period. Given the strong performance of the industry and accommodating policy settings during these four years as outlined in sections 2.2, 4.4 and 6.6.2, an analysis of political contributions made for the 2004 election cycle is warranted.

Figure 106 lists the top 10 donors (excluding lobby groups) of political contributions to both major parties in the US – the Republicans and the Democrats. Interestingly five of the top 10 list of contributors to the 2004 elections consisted of individuals involved in the finance industry (including funds management, insurance and financial services), whilst owners of home construction corporations comprise three of the top 10. These construction groups

would benefit from government favouritism towards the housing sector, whilst the four funds management corporations featured in the top 10 list would generally benefit from lighter finance related regulation.

Figure 106 - top 10 Donors (excluding lobby groups) of Political Contributions in 2004 US Election

Rank	Donor Name City / State	Corporation Affiliation	Industry	Contribution Amount (USD)
1	Herb & Marion Sandler	Sandler Foundation / Golden West Financial Corporation	Charity / Funds Management	11,050,944
	Oakland, CA			
2	Perry, Robert J. & Doylene	Perry Homes	Home Construction	8,050,000
	Huston, TX			
3	Arnall, Roland E. & Dawn L.	Ameritrust Capital	Subprime Mortgage Lender	5,000,000
	Los Angeles, CA			
4	Spanos, Alex G. & Faye	AG Spanos Companies San Diego Chargers	Home Construction	5,000,000
	Stockton, CA			
5	Pickens,T.Boone & Madeleine	BP Capital	Fund Manager	4,600,000
	Dallas, TX			
6	*Perenchio, Jerrold & Margaret	Chartwell Partners	Executive Search	4,000,000
	Los Angeles, CA			
7	Simmons, H. C. & A. C.	Contran Corp	Diversified Industrial	3,500,000
	Dallas, TX			
8	McHale, J. F. & Mattson, C. L.	Tipping Point Technologies	Information Technology	3,000,000
	Austin, TX			
9	Lewis, Peter B.	Progressive Corp	Insurance	2,985,000
	Cleveland, OH			

Rank	Donor Name City / State	Corporation Affiliation	Industry	Contribution Amount (USD)
10	Soros, George	Soros Fund Manage- ment	Funds Management	2,950,000
	New York, NY			
* Specialising in finance industry				

Source: The data used for the table was extracted from Centre for Responsible Politics (2008).

As expected, the incumbent government (the Republicans), obtained the most donations for the 2004 election cycle as shown in Figure 107. The Republicans who already displayed a preference for less regulation towards the finance sector (refer section 2.2 and section 8.2.6) accounted for 75% of total donations over USD 100,000.

Figure 107 - Political Contributions per Political Party over USD 100,000 in 2004 Election

Total Contributions	Republican Contributions	Republican	Democrat Contributions	Democrat
USD	USD	% of Total	USD	% of Total
114,752,979	86,379,491	75%	28,373,488	25%

Source: The data used for the table was extracted from Centre for Responsible Politics (2008).

According to the Centre for Responsible Politics (2008), George W. Bush personally received approximately USD 6,623,961 from the top 20 donors to his second presidential election campaign in 2004. Featuring prominently in this list are all four major US investment banks, and a number of other banks and financial institutions which, in aggregate, constitute 13 of the top 20 contributors. The amount contributed by financial institutions in the 2004 election cycle was triple that made in the 2000 cycle (Becker et al. 2008). This indicates a strong preference of the investment banking and wider financial services community for another term of a Republican government led by George W. Bush so encouraging the party to continue its neo-liberal policies (Becker et al. 2008).

Figure 108 - Top 20 Donors of Political Contributions to George W. Bush in 2004 US Election

Rank	Donor Name	Industry	Contribution Amount USD
1	Morgan Stanley	Investment Banking	604,280
2	Merrill Lynch	Investment Banking	558,804
3	PricewaterhouseCoopers	Accounting	508,500
4	UBS AG	Bank / Investment Banking	442,325

Rank	Donor Name	Industry	Contribution Amount
5	Goldman Sachs	Investment Banking	396,350
6	Lehman Brothers	Investment Banking	355,525
7	US Government	Government	334,611
8	Citigroup Inc.	Bank / Investment Banking	317,375
9	MBNA Corp	Bank	313,600
10	Ernst & Young	Accounting	304,340
11	Bear Stearns	Investment Banking	302,850
12	Deloitte LLP	Accounting	293,050
13	Credit Suisse Group	Bank / Investment Banking	279,590
14	Wachovia Corp	Non-Bank Financial Institution	273,760
15	Bank of America	Bank / Investment Banking	258,361
16	JPMorgan Chase & Co	Investment Banking	228,005
17	Blank Rome LLP	Law Firm	225,150
18	US Department of State	Government	220,280
19	Amerquest Capital	Non-Bank Financial Institution	208,130
20	Blue Cross/Blue Shield	Insurance	199,075
	Total		6,623,961

Source: The data used for the table was extracted from Centre for Responsible Politics (2008).

8.2.2 The Influence of Lobbying

Skeel (2005) summarises the interaction between business leaders and regulators succinctly as “an ongoing cat-and-mouse game between regulators, whose job is to rein in excesses... and business leaders, who push back against regulatory strictures in order to promote flexibility and innovation” (Skeel 2005a, p. 157). This section discusses the institutional influence exerted by the investment banking industry over politicians (legislators) through the lobbying process to either prevent problematic legislation, or to promote legislation favouring their industry. As an increasing volume of important legislation affecting the investment banking industry entered the political debate in the pre-GFC era, the analysis finds that the investment banking industry increased its spending commitment on lobbying. This trend was replicated by LB whose lobbying expenditure increased markedly from 2001 to 2007.

US Industry participants are well organised, through groups such as industry associations, the Chamber of Commerce, the Business Roundtable and specific lobby groups whose role is to provide resistance to unwanted legislation, and to steer public policy, ideologies and strategic initiatives which benefit an industry, or a particular organisation. Comparing the industrial sector and the public at large, Skeel (2005a) suggests that an industry representative usually possesses greater influence than groups of individuals, due to the efforts of lobby groups. Although the US public are valid participants who are potentially affected by outcomes of government legislation, their influence is more thinly spread and difficult to mobi-

lise. Mobilisation is costly, and ordinary US citizens generally do not have enough at stake to justify a campaign for reform (Skeel 2005a).

Lobbying leading to Regulatory Capture

Regulatory capture involves winning a regulatory agency's support by influential and often large commercial or political interest groups whose industry or activities the agency is charged to regulate. The support is usually at the expense of the public in whose interests the regulatory agency is supposed to act, and may take the form of regulations which are advantageous to the interest group. This process leads to the notion that the regulatory agency is being 'captured' or allowing itself to be influenced by the interest group and therefore represents a failure of the regulatory agency (Stigler 1971).

Engstrom (2013) proposes two forms of capture: materialist and non-materialist. The materialist type is defined by the regulator's motive being driven by material gain either through the 'revolving door' (explained in section 8.2.5), political contributions, concealed payments, or need for continuing government funding. Non-materialist capture is likened to a normative influence affecting the regulator whereby the regulator behaves in a similar manner to the regulated industry and inherits some of its values and culture. The normative influence can arise from a knowledge asymmetry between the regulatory environment and industry (Boxenbaum & Jonsson 2008). Engstrom (2013) suggests that this form of regulatory capture is often linked to lobbying. This concept is further explored in section 8.2.7.

The failure of regulations to provide adequate discipline to the finance industry is often linked to political influence (Acemoglu 2009; Calomiris 2009a; Johnson & Kwak 2011). It has been cited as being one of the key contributors to the GFC (Dagher & Fu 2011; Obstfeld & Rogoff 2009). Stiglitz, a Noble Prize winning economist stated in 2009, "But I think that mindsets can be shaped by people you associate with, and you come to think that what's good for Wall Street is good for America " (Veltrop & de Haan 2014, p. 2).

Igan et al. (2012, p. 5) defines lobbying as "a legal activity aimed at changing existing rules or policies or procuring individual benefits". Literature on lobbying focuses on two forms. The first category examines the impact of lobbying on specific policies which impact on industries generally (Facchini et al. 2011; Goldberg & Maggi 1999; Grossman & Helpman 1994). In the banking sector, Kroszner and Stratmann (1998) found a pattern of specialised standing committees being formed in government to deal with interest groups when considering proposed finance legislation. These dealings often result in high levels of political contributions which equally contribute to high levels of political effort in furthering interest group causes. An example cited by Kroszner and Stratmann (1998, p. 1163) found that the level of contributions by the banking lobby group were instrumental in garnering legislative support for banks entering new businesses. The second category of literature relates to the specific

lobbying efforts by individual firms seeking favourable outcomes related to their own corporate performance (Bertrand et al. 2004; Claessens et al. 2008).

In the US, lobbyists and interest groups are mostly represented in Washington, close to the legislators and policymakers. The finance industry is one such interest group which employs a number of lobbyists. Igan et al. (2012) cites a number of reasons for the finance industry's use of lobbyists. Firstly, it may signal to regulators that they are vulnerable to financial shocks in view of their limited capacity to absorb risks and therefore require preferential treatment. Preferential treatment may not only come in legislative terms but also in economic ones. For example there was continual pressure applied to the Federal Reserve System by investment banks to maintain loose monetary policy in the US to continue supporting financial and property related asset prices:

Cognitive regulatory capture of the Fed by Wall Street resulted in excess sensitivity of the Fed not just to asset prices (the 'Greenspan-Bernanke put') but also to the concerns and fears of Wall Street more generally (Buiter 2008, p. 4).

The second reason for financial institutions' use of lobbying is to rally against regulations which would restrict their lending activities and impact on financial performance (Igan et al. 2012). This would especially apply to publicly-listed financial institutions which are focused on short term profit maximisation strategies. Specialist bankers, who operate in specialised market segments with higher risk, may use lobbyists to convey their superior knowledge to regulators of a market, financial instrument, financial process or risk. In this instance, the uncertainty created in the minds of regulators of their knowledge may convince them to abstain from regulating a complex market such as the derivatives market (Burger 2006; 2011). The knowledge asymmetry can persuade regulators to adopt the investment banking industry view of a regulatory approach to certain innovative practices. The conduits which transfer the industry's norms are discussed in detail in 8.2.7. Financial institutions may also wish to create barriers to entry in their market segment, with the aim of limiting competition. Lobbyists could also be used in this regard to encourage tighter regulation for new entrants.

The influence of corporations and their lobbyists is reflected both in the legislative process and in the actual legislation that is enacted by Congress. In the 1990s, for example, business

leaders pushed through two separate federal reforms⁷³ that were designed to make it harder to bring securities law claims against companies that were alleged to have made misstatements to the markets (Armour & McCahery 2006). Another example which had important implications to the investment banking industry was the passing of The Commodity Futures Modernization Act of 2000 (CFMA) which is discussed in greater detail in sections 2.2 and 8.1. This Act effectively protected OTC derivatives transactions from regulation and oversight. Following its enactment, derivatives trading expanded dramatically – refer to Figure 78 for an indication of the growth of CDOs. Apart from legislators, a judge ruling on complaints by investors at the CFTC - the regulatory agency charged with overseeing the derivatives industry - was also found to be in support of the same industry by protecting it against investor complaints:

In a notice recently released by the CFTC, Judge Bruce Levine...had a secret agreement with Wendy Gramm, [then Chairwoman] of the agency [CFTC] to stand in the way of investors filing complaints with the agency...Gramm, wife of former Senator Phil Gramm, was accused of helping Goldman Sachs, Enron and other large firms gain influence over the commodity markets. After leaving the CFTC, Wendy Gramm joined the board of Enron (Hilzenrath 2010).

Other examples of effective lobbying by the financial sector involved the defeat of proposed bills relating to mortgage lending which would otherwise impose restrictions on the financial sector (Igan et al. 2012). The consequent lack of protection for mortgage borrowers contributed to the creation of the property bubble referred to in section 2.2 and the growth in subprime lending. Examples of bills related to mortgage lending and which were defeated are set out in Figure 109.

⁷³ These reforms were the Private Litigation Reform Act 1995, imposing enhanced pleading requirements and providing more protection for forward looking information; and the Securities Uniform Standards Act Litigation 1998, preventing most securities fraud class actions from being pursued in state courts.

Figure 109 - Examples of Defeated US Government Bills 2000 - 2008

Bill Number	Bill Name	Topic	Outcome
H.R. 3901	Anti-Predatory Lending Act of 2000	Adds the following disclosure requirement to the Home Mortgage Disclosure Act of 1975: 'the annual percentage rate of mortgage loans and home improvement loans originated by the institution grouped according to census tract, income level, racial characteristics, and gender'. The bill restricts certain rates and fees and mandates that any borrower who would like to obtain a high-cost mortgage complete home ownership counselling. Prepayment penalties, negative amortization, flipping home loans, extending credit without regard to ability to repay, encouraging default, payments to appraisers by creditors, and creditor-financing of credit insurance are disallowed.	Introduced March 9, 2000; Never passed by House or Senate; Never signed into law.
H.R. 3915	Mortgage Reform and Anti-Predatory Lending Act of 2007	Introduces licensing and training requirements for individuals wishing to become loan originators. In addition, the bill stipulates that certain federal agencies are to regulate mortgage lenders so that they do not encourage borrowers from taking on loans that they do not have the ability to repay. Good faith estimates must include the total loan amount, the type and length of the loan, the annual percentage rate, the total estimated monthly payment, the percentage the monthly payment is of the borrower's monthly income, and other disclosures.	Introduced October 22, 2007; Passed by House November 15, 2007; Never passed by Senate; Never signed into law.
H.R. 1461	Federal Housing Finance Reform Act of 2005	The Federal Housing Finance Reform Act of 2005 creates the Federal Housing Finance Agency (FHFA) which would have over-	Introduced April 5, 2005; Passed by House October 26, 2005; Never passed by Senate; Never signed

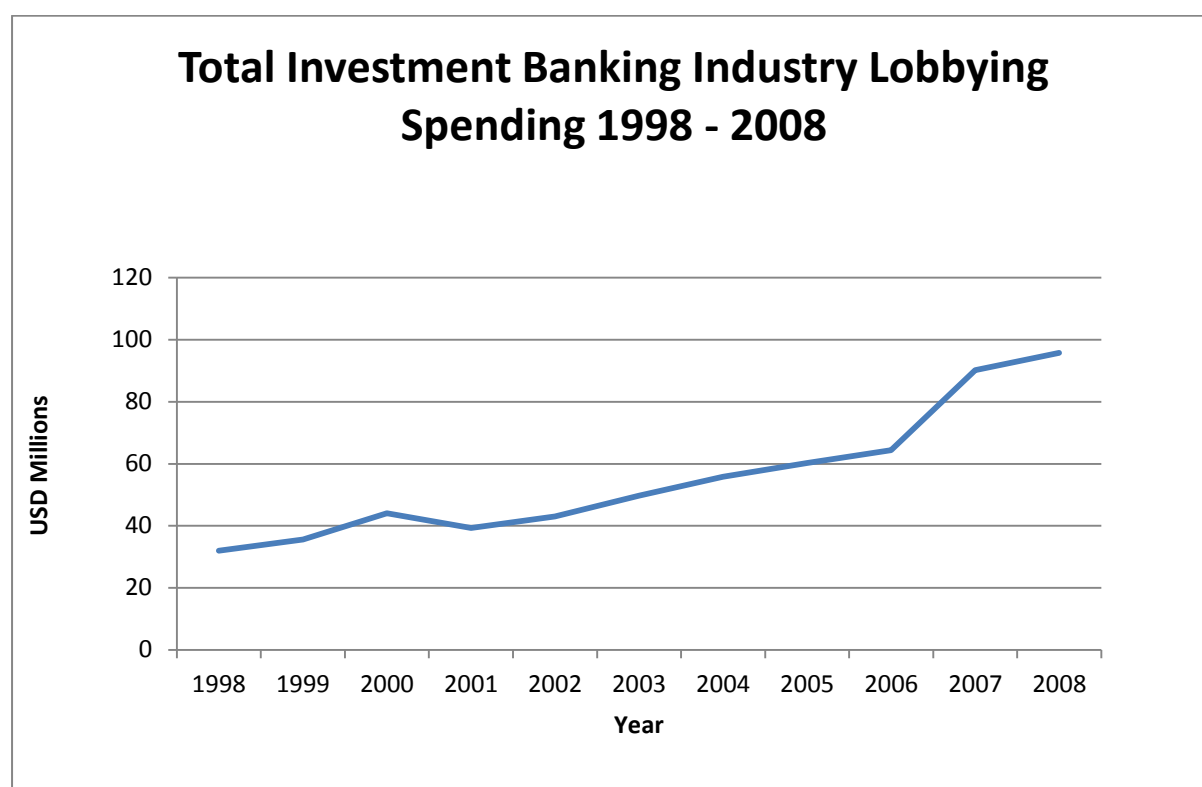
Bill Number	Bill Name	Topic	Outcome
		sight of Freddie Mac, Fannie Mae, and Federal Home Loan Banks. FHFA would become the single regulator for Freddie Mac and Fannie Mae; the Department of Housing and Urban Development would no longer have oversight. The bill requires Freddie Mac and Fannie Mae to set aside funds directed at increasing home ownership among low-income individuals or in low-income areas.	into law.
H.R. 1295	Responsible Lending Act	Defines 'higher-cost mortgage' and includes requirements for mortgage product evaluation software and appraisals for properties secured by higher-cost mortgages. In addition, mortgage pamphlets distributed to consumers are to be updated and simplified and explain topics such as balloon payments, escrow accounts, and consumer responsibilities; furthermore, information should be provided in multiple languages and formats to reach vulnerable populations.	Introduced March 15, 2005; Never passed by House or Senate; Never signed into law.

Source: The data used for the table was extracted from Igan et al. (2012, pp. 57-64).

8.2.3 Normative influence, fuelled by mimetic behaviour, rallies the troops

The combination of an increased industry spending, and an expanding use of lobbying firms by an increasing number of industry participants is indicative of a normative pressure, fuelled by mimetic behaviour amongst industry participants, to rally against regulatory strictures affecting their businesses. Refer Figure 110 for the total lobbying expenditure by the investment banking industry (including all investment banks, investment management companies and securities firms) for years 1998 to 2008. Figure 110 shows that lobbying expenditure by the investment banking industry had grown by 300% for the ten-year period from 1998 to 2008, an average of 20% per annum. This growth however accelerated significantly in the two years prior to the LB collapse, recording an average annual increase between 2006 and 2008 of 24%.

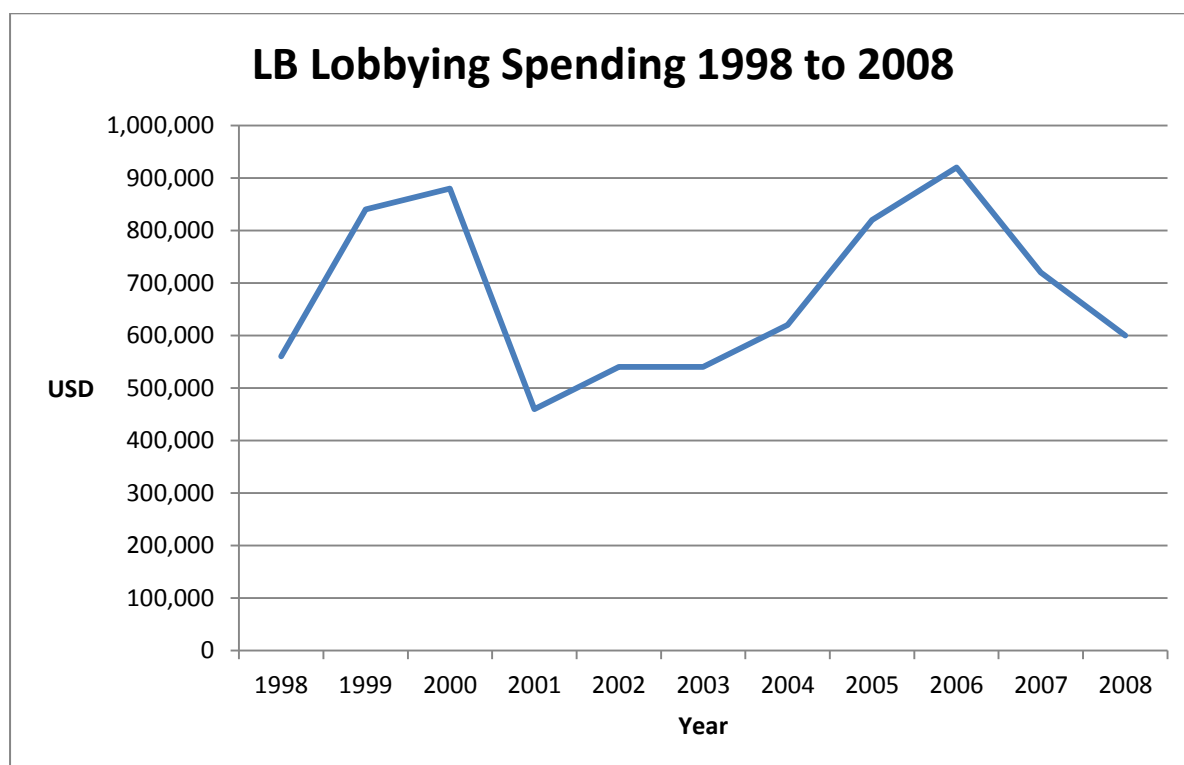
Figure 110 - Total Lobbying Expenditure by the Investment Banking Industry



Source: The data used for the graph was extracted from Centre for Responsible Politics (2008).

LB's contribution to various lobby groups also increased in the decade prior to 2008 as shown by Figure 111, declining after 2006 once the deterioration in its financial performance became apparent.

Figure 111 - LB Lobbying Spending from 1998 to 2008

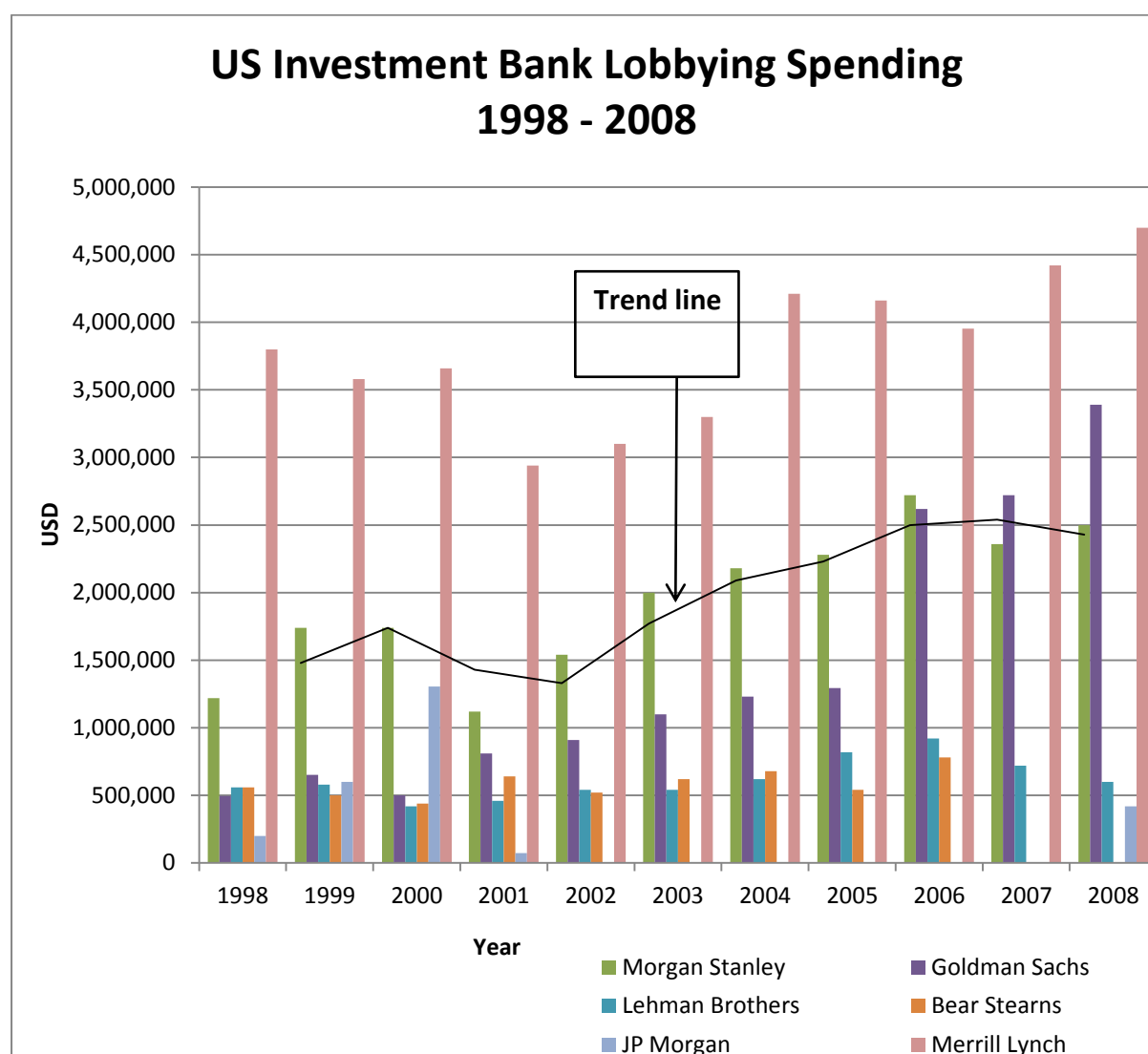


Source: The data used for the graph was extracted from Centre for Responsible Politics (2008).

According to the Centre for Responsible Politics (2017), the lobby firm mostly used by LB was DLA Piper, a global law firm with an office in Washington. This firm was used by various interested parties from several industries. DLA Piper was particularly active and in addition to LB, in 2007 represented investment banks and securities firms such as Goldman Sachs, Merrill Lynch Charles Schwab Corp, Parkwood Group, and Stanford Financial Group (Centre for Responsible Politics 2008). Therefore DLA Piper would have been familiar with the topics of interest to the 'financial network'.

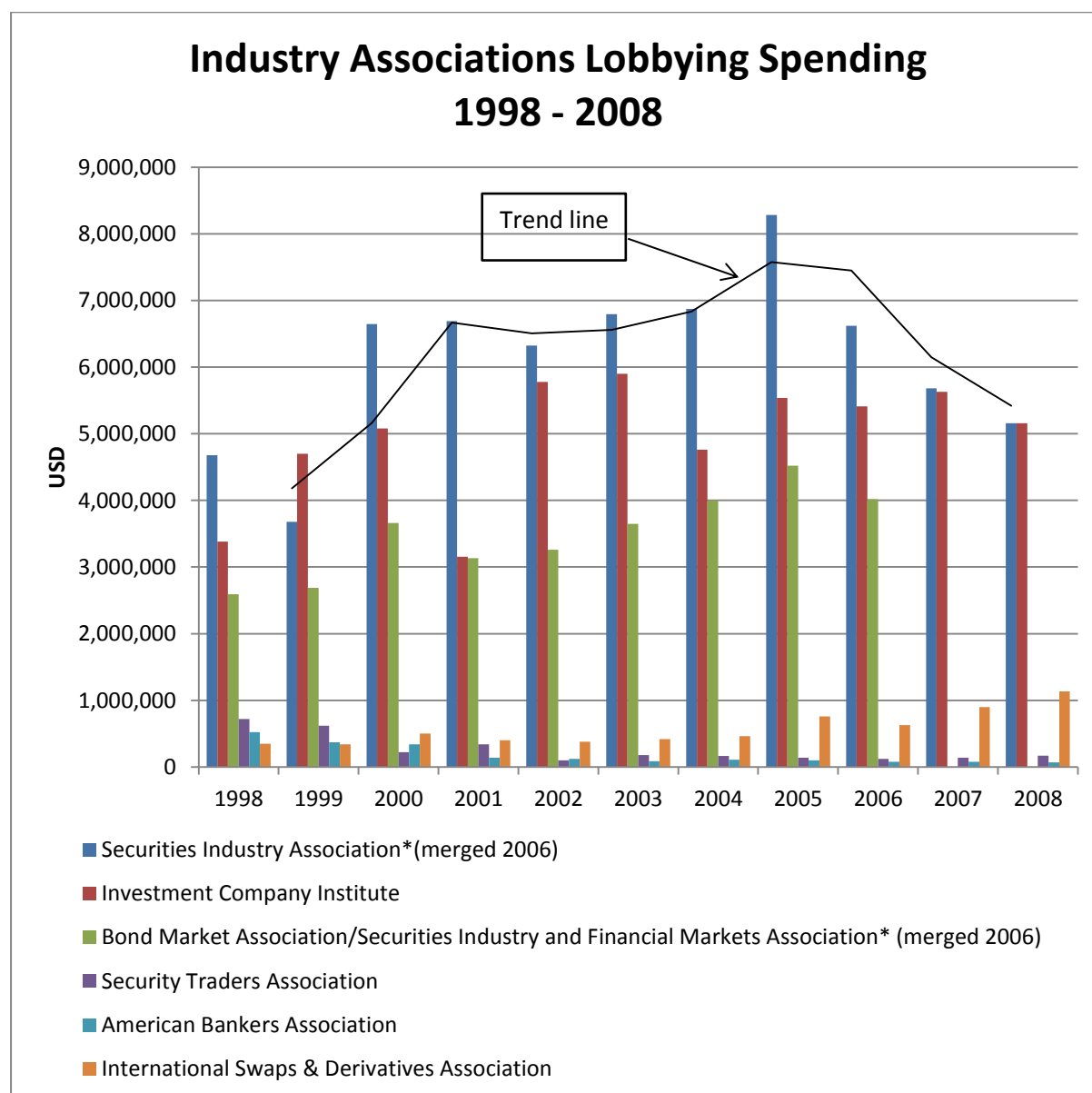
In order to ascertain the major US investment banks' and related industry associations' lobbying spending during the decade prior to the GFC, data was extracted from the Centre of Responsible Politics database for each major investment bank and major industry association for the years 1998 to 2008. Figure 112 shows that the lobbying spending for the US investment banks followed the same increasing trend until 2006/2007 as shown in Figure 110. A similar pattern of lobbying spending is also evidenced by the main associations representing the investment banking industry as depicted in Figure 113.

Figure 112 - Lobbying Spending of Major US Investment Banks 1998 - 2008



Source: The data used for the graph was extracted from Centre for Responsible Politics (2008).

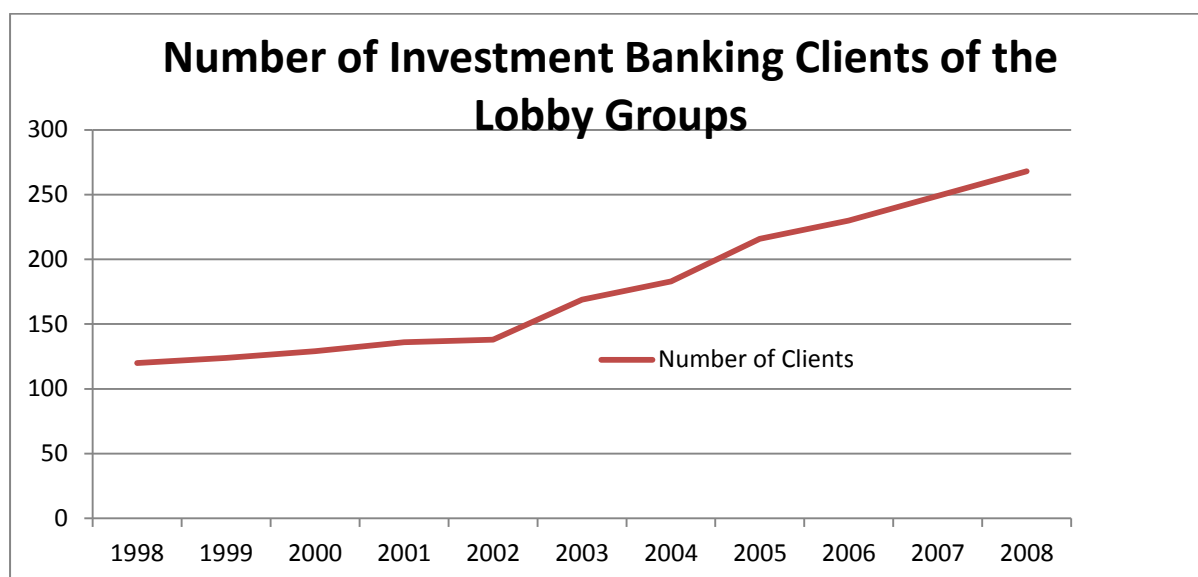
Figure 113 - Lobbying Spending of Major Industry Associations 1998 - 2008



Source: The data used for the graph was extracted from Centre for Responsible Politics (2008).

As the investment banking industry expanded and the number of political issues affecting the industry increased in the pre-GFC period, the number of investment banks and securities firms which employed lobby groups (clients) also increased, as depicted in Figure 114.

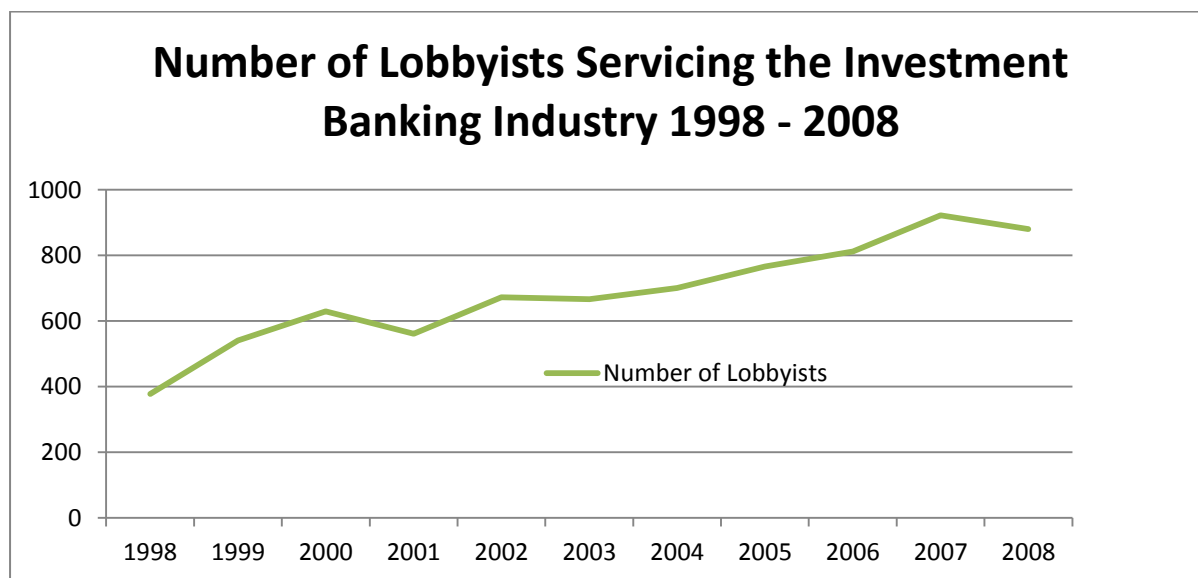
Figure 114 - Number of Investment Banking Clients of the Lobby Groups



Source: The data used for the graph was extracted from Centre for Responsible Politics (2008).

Figure 115 shows a commensurate growth in the number of lobby groups servicing the investment banking industry. This growth in the number of lobby groups was driven by the increased demand for lobbyists and the growth in the number of political issues being faced by the industry (Centre for Responsible Politics 2011).

Figure 115 - Number of Lobbyists Working for the Investment Banking Industry



Source: The data used for the graph was extracted from Centre for Responsible Politics (2008).

According to Centre for Responsible Politics (2011), the investment banking industry's primary issue for lobbying was market trading business activities such as stockbroking and bond dealing. In this case the industry attempted to either postpone or prevent interventionist legislation. Additionally, given the focus on expanding the investment banks' business of securitising pools of mortgages, a concerted effort was made to engender demand in the mortgage market, including the freedom to operate within the market which is exemplified by the defeated bills noted in Figure 109.

Normative Influence

Given that the preservation of favourable business conditions advantaged financial performance of the finance industry, the practice of lobbying became a social norm, affected by a normative influence in the industry's attempt to achieve its objectives. The practice of lobbying had been an historic practice enshrined in the US by various interest groups. Its adoption by the investment banking industry was a continuation of this trend in the US political arena. It was not only sustained for a long period, but intensified in the decade preceding the GFC. A social acceptance permeated the industry that a sustained lobbying effort was necessary to ensure growth at best and survival at worst by ensuring a regulatory framework which was favourable to the industry.

Legislators also came to accept this practice as socially acceptable and therefore normal, just as political contributions were deemed acceptable as a systemic way of funding elections. The view on both sides of the lobbying fence reflected a common understanding amongst professionals, that a constructive debate should take into account a diversity of views. Politicians were receptive to lobbying efforts as they desired to be viewed as open to all special interest groups wanting to convey a message, and therefore appear as legitimate political representatives in the eyes of constituents. As with many debates, however, those with the loudest voice and greatest resources could often put forward the most compelling point of view (Skeel 2005a).

The investment in lobbying could be likened to a moral obligation to support the common effort of maintaining trading conditions sympathetic to the industry. Given that lobbying was successful in preventing certain bills being passed as outlined in Figure 109, it is deemed a successful instrument in the arsenal of the investment banking industry and an acceptable form of communicating a point of view. The receptive nature of the legislative and regulatory communities to lobbying suggests that a normative influence was exerted on the 'financial network' whereby the practice of lobbying was an accepted norm.

Mimetic Influence

The mimicking behaviour of the industry in using lobbyists is also explained by DiMaggio & Powell's (1983) mimetic isomorphism where organisations are inclined to imitate those or-

ganisations which they deem successful and legitimate. As the larger investment banks increased their commitment to lobbying spending, the rest of the industry followed suit as they sought direction for the best course of action from their professional network - a concept proposed by Galaskiewicz (1985).

The increase in industry lobbying spending, and the increasing number of lobby firms engaged by an increasing number of investment banks provides evidence that industry participants were responding similarly and with greater intensity to regulatory issues as an interest group. Industry associations championed the same efforts and carried the weight of an organised representative group with deeper resources to commit to the lobbying effort as shown by Figure 113 and presumably this enhanced their access to policymakers. The common push to preserve the relatively liberal operating environment supports the notion of a mimetic behavioural pattern amongst investment banks.

The transfer between firms of the norm associated with lobbying spending usurped any internal preference to behave differently and spawned mimetic behaviour. Conformity to the practice of lobbying therefore became institutionalised and accepted by many industry participants and is consistent with the notion supported by (Zanna 1991) of the adoption by a group of a practice where there is a commonality of purpose. It became a practice of conventional wisdom which would assist in providing standardised conditions favourable to the individual firm as much as to the industry at large.

Igan et al. (2012) also suggests that underperforming financial institutions may use the same lobbyists to lobby on the same issues as successful financial institutions so as to persuade regulators that they should also be regarded as successful. Through the application of political pressure as a unified group, the investment banking industry was able to reinforce the communication of its positions on policy to the relevant regulatory agencies and legislators. This behaviour is particularly found in organisations in the same field where underperforming organisations wish to enhance prestige and reputation, both attributes critical elements for an investment bank.

8.2.4 Political Contributions and Lobbying as Coercive Pressure

The US process of enacting legislation involves a prior review by specific Congress committees prior to being submitted for voting. As committee members hold important positions in this process, they are subject to special attention and offers of contributions from lobby groups representing industries over which they have a regulatory influence. Figure 104 shows that most of the top 10 recipients of political contributions are members of either a congressional or senate committee related to the finance industry. Members of Congress are continually raising funds for re-election purposes by attending fundraising events and

soliciting funds from wealthy donors. This is a normal practice in the US. However, it brings with it the risk of undue influence in the legislative making process. Moreover, committee members and other politicians are subject to a barrage of competing petitions from interest groups.

As mentioned in CHAPTER 3, Dobbin and Sutton (1998) Edelman (1992) and Edelman et al. (1999) noted that organisations are active in influencing the content of legislation. Often this occurs when legislation covers complex matters and the intention of organisations is to ensure the proposed legislation reflects best practice. This thesis is supported by the notion that New Institutional Theory involves “a political process, and the success of the process and the form it takes depends on the relative power of the actors who strive to steer it” (Powell 2008, p. 5). This notion of New Institutional Theory reflects the way the investment banking industry sought to influence the regulatory and legislative process through coercive pressure. Sahlin-Andersson and Engwall (2002) also suggest that institutionalisation is subject to political forces. The same study argued that management consultants, accounting standard setters and the media are important transmitters of opinions to encourage institutional change.

Political groups and house committees - part of government, are claimed to be subject to the coercive pressures associated with the abovementioned political contributions and lobbying. The government subjects may succumb to this pressure from a threat of a reduction, or at worst a cancellation of future re-election support. The support is mainly in the form of political contributions or in a more subtle method, by way of negative campaigning against the committee, group or politician being lobbied. Given the political contributions of the investment banking community had been substantial as mentioned in section 8.2.1, any withholding of future contributions upon which politicians relied, would have exerted significant financial pressure on the chances for election or re-election as funds are needed for a variety of reasons in the election process, such as advertising.

This pressure was directed to individuals in the relevant committees and to those in senior executive positions within the respective political parties. Compliance to the wishes of the donors and the lobby groups would have improved the probability of securing ongoing future funding, hence long term political survival. A tenet of DiMaggio & Powell's (1983) coercive pressure involves an organisation acting in a certain manner to impose its will, whether subtly or directly, on another organisation to comply with certain actions or behaviours in return for legitimacy and its subsequent benefits. Investment bankers imposed their will on the political system through their lobbying efforts and increasing levels of political contributions. In return, politicians gained legitimacy through the repetitive practice of attracting and accepting political contributions. As long as donors continued to offer contributions, and directed them to their preferred political party, they held certain power over election outcomes. Donors also reinforced the perception of politicians as important decision makers

vital to the well-being of the financial community. A continuance of contributions sent signals to the wider community that certain politicians were pursued by large industry players and therefore validated their worth. As donors from the investment banking industry generally comprise educated professionals with expertise in economics and the financial markets, their support for Bush in 2004 was viewed by many voters as a validation of his neo-liberal economic approach.

8.2.5 Influence through the ‘Revolving Door’

Influence in the legislative process is not only achieved through political contributions and well-orchestrated lobbying, but also through a practice of revolving personnel between the key participants in the financial network and government offices. In the US the term ‘revolving door’⁷⁴ refers to this practice. The most successful university graduates seeking employment with investment banks often seek out those investment banks leading the published industry league tables. The reverse of this is also the case where leading investment banks prefer to recruit high achieving students (McDowell 1997). Consequently, investment banks are staffed with high quality individuals who are keenly sought within the finance and commercial sectors, as well as in senior government positions. Given the vast opportunities available to the pool of high achieving investment bankers, staff mobility amongst the profession is considered high, leading to an industry which is subject to the ‘revolving door’ (Rajan 2010). As Rajan (2010) noted, “an investment banker’s view of the world is unlikely to change. This phenomena leads to cognitive capture”⁷⁵.

Lobby groups gain personal access and exert influence through strong connections with public servants. The latter group consists of politicians and regulators formed by former federal employees who are later employed in industry or as lobbyists, consultants and strat-

⁷⁴ In politics, the ‘revolving door’ concept refers to the switching of an individual’s employment between government, regulatory authorities and the industries they supervise. A danger to this practice is the undue influence that can be exerted on regulators and government to establish biased public policy in favour of the private sector. This notion is known as regulatory capture.

⁷⁵ Regulatory capture has two forms consisting of cognitive capture or materialist capture. Materialist capture occurs when the regulator’s motive is based on material self-interest. This can result from bribery, political donations, or the regulator’s desire to maintain its government funding. Cognitive capture occurs when regulators views and beliefs are shaped by the regulated industry. The process of industry lobbying is often a contributor to cognitive capture.

egists. The opposite also applies as industry participants switch between private and public sectors. As connections are developed, so too does privilege, power, access and funding (Senate Office of Public Records Government of the USA 2011). Investment banking professionals and their lobbyists are considered useful employees for government and regulators given their knowledge and experience in the financial and commercial sectors and their connections and influence within industry. These attributes are desired by government as it attempts to develop the knowhow to initiate relevant regulations affecting the finance industry or to gain political support in the form of validation of policy or donations from the private sector. On the hand, the investment banking industry has an appetite for hiring government employees to facilitate personal access to key regulators and policymakers, in an attempt to influence regulatory outcomes. The regulators have been accused of using a 'light touch' with investment banking regulation as they hope to seek more lucrative remuneration with those they regulate in later life after their public service employment (Tammy 2014). Additionally (Burger 2006) and (Tammy 2014) suggest that Federal Reserve regulators avoid complex regulation as they recognise a divergence between the skill levels of professionals in the industry and the regulators. The appointment of an ex-government official can also assist in winning lucrative government contracts such as major financing or advisory mandates for clients of the lobby groups.

An examination of the Centre For Responsible Politics database reveals that since data collection commenced in 1974, between the three key regulatory agencies (the Department of the Treasury; the Federal Reserve System; and the Securities & Exchange Commission) which interacted with the investment banking industry, a total of 353 officers had also worked either in the investment banking industry or for an associated lobby group (Centre for Responsible Politics 2011). Figure 116 sets out the number of staff who have been through the 'revolving door' where their current or former place of employment was with one of the three agencies.

Figure 116 - 'Revolving door' Staff of Regulatory Agencies

Government Agency	Number of Staff	% of Total
Department of the Treasury	203	57
Securities & Exchange Commission	116	33
Federal Reserve System	34	10
Total	353	100

Source: The data used for the table was extracted from Centre for Responsible Politics (2008).

Hilzenrath (2010) conducted an empirical study examining the SEC's track record of enforcement against investment banks and brokerage houses before 2007, and found indirect evidence that some financial institutions received favourable treatment by regulators once

agency employees were employed in the finance industry at higher salaries (Hilzenrath 2010, p. 725). The finding indicated a systemic pattern of the ‘revolving door’ practice between SEC employees and industry. The Project on Government Oversight (POGO) which is a US non-partisan independent watchdog that advocates good government reforms investigated some impacts of the ‘revolving door’ on the SEC and produced a report for use by the US Congress. POGO specifically examined former SEC employees who after leaving the SEC were employed by organisations overseen by the SEC. Its findings included that:

between 2006 and 2010, 219 former SEC employees sought to represent clients before the SEC. Former employees filed 789 statements notifying the SEC of their intent to represent outside clients before the commission, some filing within days of leaving the SEC (Smallberg 2011, p. 2).

A case was made by (Smallberg 2011) that implicated SEC employees as subjects of a conflict of interest between the SEC and industry:

The SEC Office of Inspector General has identified cases in which the revolving door appeared to be a factor in staving off SEC enforcement actions and other types of SEC oversight, including cases involving Bear Stearns (Smallberg 2011, p. 2).

The ‘revolving door’ practice was entrenched in the investment banking industry for some time. Refer Figure 117 for the employment history of a sample of recent US Treasury Secretaries such as Tim Geithner, Henry Paulson, Robert Rubin, and Lawrence Summers which shows them passing through the ‘revolving door’.

Figure 117 - Selection of US Treasury Secretaries Passing through the ‘Revolving Door’

Tim Geithner		
Period of Employment	Employer	Title
2014-present	EM Warburg, Pincus & Co (Investment Bank)	President and Managing Director
2009-2013	Department of the Treasury	Secretary of the Treasury
2003-2009	Federal Reserve System	President, Fed Reserve Bank of New York
2001-2003	International Monetary Fund	Director, Policy Development & Review
2001-2001	Council on Foreign Relations	Senior Fellow, International Economics

1988-2001	Department of the Treasury	Undersecretary for International Affairs
1985-1988	Kissinger Associates	Consultant

Henry Paulson		
Period	Employer	Title
2009-present	Johns Hopkins University	Distinguished Visiting Scholar
2006-2009	Department of the Treasury	Secretary of the Treasury
1974-2005	Goldman Sachs (Investment Bank)	CEO
1972-1973	White House	Employee/Staff
1970-1972	Department of Defence	Staff Assistant

Robert Rubin		
Period	Employer	Title
2007-present	Council on Foreign Relations	Vice Chairman
1999-present	Citigroup (Commercial / Investment Bank)	Executive Committee Chairman
1995-1999	Department of the Treasury	Secretary of the Treasury
1993-1995	National Economic Council	Director
1966-1992	Goldman Sachs (Investment Bank)	Co-Chairman

Lawrence Summers		
Period	Employer	Title
2009-present	National Economic Council	Director
2006-2008	DE Shaw & Co (Investment Bank)	Managing Director
2002- present	Brookings Institution	Board of Trustees
2002- present	Committee for Economic Development	Board of Trustees
2001- present	Council on Competitiveness	Member
2001-2001	Brookings Institution	Senior Fellow
2001- present	Centre for Global Development	Board of Directors
2001-2005	Global Fund for Children's Vaccines	Board of Directors
2001-2006	Harvard University	President
2001- present	Partnership for Public Service	Board of Governors
2001- present	Trilateral Commission	Member

2001- present	Bretton Woods Committee	Member
2001- present	Institute for International Economics	Board of Directors
2001-present	Inter-American Dialogue	Member
1999-2001	Department of the Treasury	Secretary of the Treasury
1997- present	Group of 30	Member
1995-1999	Department of the Treasury	Deputy Secretary
1993-1995	Department of the Treasury	Undersecretary
1991-1993	World Bank Group	VP of Development Economics
1989-1992	American Economic Association	Executive Committee
1989- present	Council on Foreign Relations	Member
1988-1990	American Economic Association Commission on Graduate Education	Member
1987-1991	Harvard University	Professor of Political Economy

1986-1990	Congressional Budget Office	Board of Advisors
1983-1987	Harvard University	Professor of Economics
1982-1983	Council of Economic Advisers	Domestic Policy Economist
1982-1982	Massachusetts Institute of Technology	Associate Professor of Economics

Source: The data used for the table was extracted from Centre for Responsible Politics (2008).

Other notable Secretaries of the Treasury passing through the ‘revolving door’ include: Robert Kimmit, ex-Managing Director of LB; Douglas Dillon and Nicholas Brady of Dillon Read and William Simon of Salomon Brothers (Inside Gov 2017). Even Pete Peterson former CEO of LB served as Secretary of Commerce before joining LB. Historically, the relationship between investment banks and government has been important since government has also relied heavily on the industry to finance a large part of their borrowings, even as far back as the Revolution, refer CHAPTER 4.

Apart from the Treasury department key leaders from the Federal Reserve System also worked in the investment banking industry prior to and after ascending to their influential government positions. Alan Greenspan was one of the key regulators during the critical pre-GFC period as Chairman of the Federal Reserve from 1987 to 2006. The normative influence affecting the Federal Reserve was also evident in the loose monetary policy it initiated during this period which was considered dangerous:

Both the 1998 LTCM and the January 21/22, 2008 episodes suggest that the Fed has been co-opted by Wall Street - that the Fed has effectively internalised the objectives, concerns, world view and fears of the financial community. This socialisation into a partial and often distorted perception of reality is unhealthy and dangerous (Buiter 2008, p. 106).

The intensive lobbying efforts of the investment banking industry had ‘co-opted’ the Federal Reserve into a culture of continued growth for the financial markets. This culture as explained throughout this thesis was consistent with the strategy driving the industry (refer CHAPTER 7) and that of LB (refer CHAPTER 10). The actions of the Federal Reserve were socially sanctioned not only by the investment banking industry but by other members of so-

ciety who had an interest in escalating asset prices. The Federal Reserve complied with the expectations of industry as it considered the adopted policies were socially sanctioned and a proper course of action for the good of society generally. Support for the Federal Reserve's actions came from professionals with a wide industry representation, especially the financial markets. As well-educated, professional individuals, the financial market experts validated the Federal Reserve's monetary policy stance. This wider group of beneficiaries of the loose monetary policy settings only reinforced the Reserve Bank's resolve and belief that lower interest rates were good for the economy and therefore continued to promote them for almost a decade. The term associated with this policy was the 'Greenspan-put' or later referred to as the Greenspan-Bernanke put⁷⁶. The view that a continuation of low interest rates would benefit the financial markets by buoying asset prices, particularly in the equity and debt securities and property markets was founded on the belief that these markets were essential to the continued prosperity of the financial network which was essential to a healthy economy:

... it seems pretty evident to me, that the Fed under both Greenspan and Bernanke has cut rates more vigorously in response to sharp falls in stock prices than can be rationalised with the causal effects of stock prices on household spending and on private investment, or with the predictive content of unexpected changes in stock prices (Buiter 2008, p. 106).

Refer section 6.6.20 for a discussion of the prevailing economic climate during this period and Figure 86 for a graph displaying the decreasing trend of the Fed Funds Rate in line with Greenspan's accommodative monetary policy stance. Greenspan had a long association with the finance industry. Following his studies, Greenspan worked with Brown Brothers Harriman, in the firm's equity research department (Greenspan 2007, p. 41). Greenspan had a high regard for the firm which had a history of participating in the 'revolving door':

Brown Brothers Harriman was among New York's oldest, largest, most prestigious investment banks - W. Averell Harriman, the legendary statesman, had been a general partner before going to work for President Roosevelt and Prescott Bush, father of President George H. W. Bush and grandfather of President George W. Bush, served there as a partner both before and after his tenure in the U.S. Senate From 1948 to 1953 (Greenspan 2007, p. 31).

⁷⁶ The term referred to the pattern of successive interest rate cuts initiated by the Federal Reserve following the bankruptcy of Long Term Capital Management in October 1998.

Greenspan also worked for a finance industry consultancy and ‘think tank’ known as The Conference Board from 1955 to 1987 (Greenspan 2007). During his tenure with the Federal Reserve, Greenspan concurrently held the position of Chairman and President of another economics consultancy firm, Townsend-Greenspan & Co which also provided services to the finance industry (Greenspan 2007). Greenspan’s involvement with industry extended to Board memberships on corporations such as Aluminium Company of America (Alcoa); Automatic Data Processing; Capital Cities ABC Inc.; General Foods; J.P. Morgan & Co; Morgan Guaranty Trust Company; Mobil Corporation; and the Pittston Company (Pottruck 2005).

Ben Bernanke was Chairman of the Federal Reserve during the height of the GFC, between 2006 and 2014. Although Bernanke’s career prior to commencing in his role at the Federal Reserve was in academia, he succumbed to the temptation of working in industry after retiring from the Federal Reserve. In 2015, Bernanke joined a hedge fund known as Citadel as a senior advisor. The fund managed USD 25 billion in assets and is considered one of the largest funds of its type in the US (Sorkin & Stevenson 2015).

Other recent president and chief executive officers of the Federal Reserve Bank of New York who immediately preceded Geithner, included Gerald Corrigan who served in that capacity from 1985 until 1993 and William McDonough who served from 1993 to 2003. Immediately following his career at the Federal Reserve, Corrigan was appointed Managing Director at Goldman Sachs in 1994 and soon became Chairman, retiring in 2016 (Federal Reserve Bank New York 2017a). Prior to joining the Federal Reserve, William McDonough worked for US bank, First Chicago Corporation and its subsidiary bank, First National Bank of Chicago for 22 years. McDonough retired from First Chicago Corporation in 1989. Upon his retirement from the Federal Reserve, McDonough was appointed to serve as the first chairperson of the Public Company Accounting Oversight Board (established by the Sarbanes-Oxley Act of 2002) in Washington, DC. He served in that post until 2005. McDonough eventually returned to the investment banking industry as Vice-Chairman and special advisor to the Chairman at Merrill Lynch & Co. until his retirement in 2009 (Federal Reserve Bank New York 2017b).

As mentioned in section 5.2.1, Fuld also carried a degree of influence. In addition to his other roles, Fuld was a member on the Board of Directors of the Federal Reserve Bank of New York. He held this position from March 2005 and was re-elected in January 2008, resigning a short time before the failure of LB (Federal Reserve Bank New York 2007). Further, LB was able to maintain a connection with regulators through its Chief Legal Officer, Russo, whose influential connections are documented in section 5.2.6.

8.2.6 Empirical Evidence that Connections Count

Using an empirical analysis, Igan and Mishra (2011) found that political contributions, the ‘revolving door’ and the use of lobby groups had an effect on the legislative and regulatory

process. Their findings confirm the proposition that firstly lobbying expenditures by financial firms, including investment banks, influenced the votes within government on industry related legislation proposed in the years prior to the crisis. As lobbying on proposed financial legislation intensified, Igan and Mishra (2011) found that a legislator would alter their position to favour a more liberal legislative stance in a subsequent reintroduction of the related piece of legislation to the House of Representatives. This link was found to be statistically significant. Secondly, Igan and Mishra (2011) found that the stronger the connection between lobbyists and legislators, the greater the probability of a legislator changing their vote in favour of the lobbyists position. The strength of the connection was associated with the amount of political contribution donated by the lobbyist to the legislator. Thirdly, Igan and Mishra (2011) found that a politician's party affiliation influenced whether a legislator was in favour of deregulation. The propensity to support deregulation was higher for a Republican legislator than for a Democrat and greater still if the legislator had previously worked in the investment banking industry. This empirical analysis is supplemented by other studies on this phenomenon. Malmendier and Schmidt (2011), for example, in a study using an experimental methodology, found that the giving of a donation or gift is able to persuade the decisions of the recipient in a way that benefits the giver. The favourable response by the recipient is achieved despite knowing that the intention of the giver is to influence the recipient.

The culture of an organisation also has an impact on whether they engage in lobbying to affect a regulatory stance. Igan et al. (2012) found that those financial institutions whose lending policies supported riskier credits and processes during the period between 2000 and 2006 were more inclined to use lobbyists. These same more credit risk-aggressive financial institutions experienced a higher level of financial distress from the GFC. Igan and Mishra (2011) and Igan et al. (2012) therefore established an empirical foundation for the link between lobbying by the finance industry to the establishment of a lenient regulatory environment, permitting a less conservative lending culture. Stratmann (2002) with an empirical study, established that campaign contributions affected voting choices by legislators on bills related to financial regulation. Mian et al. (2013) in a study of six bills introduced prior to the GFC, also found that subprime mortgage lenders influenced government policy toward subprime mortgage credit expansion. Bertrand et al. (2014) found that lobbyists form connections with particular politicians and follow their various committee roles in government in order to influence their respective committee's decisions. Therefore, the case for the influence over the regulatory and legislative process is confirmed by previous literature.

8.2.7 Knowledge Asymmetry as Normative Pressure

As mentioned in section 6.2 the pace of financial innovation which emerged in the 1980s had accelerated during the 1990s and 2000s. This particularly affected the securitisation field which spawned a variety of derivative products and complex financing structures.

These structures were even found to be too complex for the CRAs to fully comprehend and assign appropriate credit risk ratings as was later revealed in the financial crisis enquiry (Financial Crisis Enquiry Commission 2011). In this environment, where rampant innovation was created by the investment banking industry, a natural knowledge asymmetry developed between industry participants and the regulators. After all, in the absence of a formal consultative process between industry and regulators, how could the regulators understand the complex financial products prior to their distribution? The notion that 'industry knows best' in a fast-paced environment where no immediate risks were discerned was adopted by regulators. This approach was consistent with the neo-liberal political atmosphere at the time as described in section 2.2.

The professionals employed by the regulatory agencies were expected to have a knowledge and skill base commensurate with those in the industry they were supposed to regulate. However a knowledge asymmetry existed which gave rise to normative pressures being exerted upon the regulators. As mentioned in section 3.1.30, normative pressures are present as a consequence of professionalism. As the formal qualifications (consisting of tertiary education in the business, economic and finance fields) required for individuals in the two groups consisting of regulators and the 'financial network' are largely similar, it is suggested that employees of both groups were members of the same professions in a broader technical sense. Whilst the finance industry originally developed complex products and structures for financial transactions, the accounting profession was involved in their accounting and auditing; the legal profession was concerned with their documentation; and the CRAs developed methodologies to apply the respective ratings. In the meantime, regulators were responsible for overseeing their regulatory compliance. All groups therefore were required to share the same professional knowledge necessary to fully understand these innovations. The condition for normative pressure to exist accepts the concept that individuals within certain professions exhibit norms and cultural behaviours that are linked to their occupation.

The complex derivative products and financial structures deployed in the marketplace found acceptance by industry and their customers generally. The pressure was on the professionals within the regulatory agencies to accept these practices as information about them filtered through the professional networks, the same networks that were affected by the 'revolving door'. As the financing practices became norms amongst professionals within the private enterprise groups, the normative pressure exerted resulted in these 'practice' norms being adopted by the same professionals within the regulatory agencies which included the Securities Exchange Commission, Federal Reserve, NYSE, Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, Federal Financial Institution Examination Council. For a list of the responsibilities of each agency, refer to Figure 129.

The resultant adoption of these practices challenges the principle that regulators have a responsibility to act in the public interest, given society bears the cost of regulation. This notion is consistent with public interest theory which proposes that regulation is necessary to protect the public interest (Deegan 2009). The regulator has a responsibility to balance the costs of regulation with its social benefits with regards to more effective financial markets (Scott 2003, p. 448). The responsibility to the public can be viewed from a number of perspectives. Deegan (2009) suggests that regulation is necessary due to the following reasons: markets are inefficient and without comprehensive information available to the markets, individual investors could be negatively impacted from relying on insufficient disclosures; there are power imbalances between investors which may affect their relative access to reliable information; investors can be affected by fraudulent organisations publishing misleading information; and regulation encourages comparability between organisations due to requirements to produce information using uniform methods. These responsibilities entail 'professional' conduct, a hallmark of which encompasses ethical considerations. Key features of the expected professional conduct by regulators include transparency and independence in their everyday activities (Dellaportas et al. 2005).

Not only were the investment bankers innovative with products and financial structures, they also introduced new concepts in corporate finance. An example of the contribution of new knowledge from the investment banking industry include the concept of value at risk (VaR), which provides a measure of expected loss on a financial instrument resulting from the variation of an underlying price or rate. JP Morgan Chase was responsible for the development of the VaR concept which has since been commonly applied by the finance industry. It is also used by the peak bank supervisory body, the Bank of International Settlements in its Basel guidelines governing market risk (Ferguson). Further examples of investment banking influence on institutional practices include: the classification by Goldman Sachs of an emerging economic grouping known as 'BRIC' (acronym for Brazil, Russia, India and China). Additionally, Morgan Stanley developed a set of indices used to categorise and provide a measure for equity markets known as MSCI⁷⁷ indices. Investment banks have also been involved in introducing and developing the corporate finance concept of economic value, and

⁷⁷ Morgan Stanley developed the Morgan Stanley Capital International (MSCI) indexes. MSCI indexes are widely used as the benchmark indexes by which, the performance of global equity portfolios are measured.

using stock prices as an essential forward looking measure of the valuation of a corporation (Ho 2009).

The attitude whereby professionals within the investment banking industry were viewed as thought leaders within their profession fostered a lax approach to the regulatory process. Regulators deferred the development of intellectual capital to the industry they were supposed to be supervising. The regulators obviously did not fully understand the consequences or implications of such innovation as was proved with the subsequent corporate and banking failures. In the modern era, the emergence of CRAs in the 'financial network' introduced another party potentially subject to normative influence. As CRAs became an essential conduit for investment banks to successfully execute their securities transactions, any influence over their activities would become advantageous. The following sections explore the means by which this influence was exercised.

8.3 Credit Rating Agencies – Under the Influence

This section explains how through their commercial support of the CRAs and by providing them direct feedback on the rating models employed, investment banks were able to exert influence to achieve their desired outcomes. Section 8.3.2 shows that regulator agencies also acted to influence the ratings process. Coffee et al. (2010, p. 1) define credit ratings as symbols that "provide an opinion on the relative ability and willingness of parties with debt obligations to meet financial commitments". They claim that credit ratings have three functions: "to measure the credit risk of the issuer; to provide a means of comparison; and to provide a common standard" (Coffee et al. 2010, p. 1). The international credit rating market is dominated by three major agencies, S&P, Moodys and Fitch which together constitute a natural oligopoly, representing more than 90% of the market (Coffee et al. 2010, p. 1). The ratings provided by CRAs are designed to inform investors with independent and well researched information on the risk profile of issuers of debt securities. CRAs however failed in

these responsibilities, exacerbating the 2007/2008 financial crisis⁷⁸. Their contributory role extended from publishing inflated ratings of financial institutions and more significantly securitisation vehicles holding risky mortgage-related products such as subprime mortgages. This indictment, is promoted by a view that CRAs are fundamentally subject to conflicts of interest (Coffee 2011, p. 232). This allegation came to a head in a case filed by the US Department of Justice and subsequently settled by S&P (the defendant):

Department of Justice and 19 states and the District of Columbia have entered into a USD 1.375 billion settlement agreement with the rating agency Standard & Poor's Financial Services LLC, along with its parent corporation McGraw Hill Financial Inc., to resolve allegations that S&P had engaged in a scheme to defraud investors in structured financial products known as Residential Mortgage-Backed Securities (RMBS) and Collateralized Debt Obligations (CDOs). The agreement resolves the department's 2013 lawsuit against S&P, along with the suits of 19 states and the District of Columbia. Each of the lawsuits allege that investors incurred substantial losses on RMBS and CDOs for which S&P issued inflated ratings that misrepresented the securities' true credit risks. Other allegations assert that S&P falsely represented that its ratings were objective, independent and uninfluenced by S&P's business relationships with the investment banks that issued the securities (US Office of Public Affairs 2015).

In the process of settling the lawsuit, S&P admitted facts demonstrating that it misrepresented itself to investors and the public, by issuing bias ratings in its attempts to maximise profits (US Office of Public Affairs 2015). The above statement issued by the US Department of Justice alludes to the complicity of the CRAs in disseminating misleading ratings on CDOs arranged by various investment banks prior to the GFC. Although the lawsuit focused on S&P as the defendant, the assertions mentioned therein are relevant to other major CRAs operating in the industry (Coffee et al. 2010; Leaders of The G20 2009; US Office of Public Affairs 2015).

The major criticism of the CRAs' approach revolves around the 'issuer-pays' model used prior to the GFC (Coffee et al. 2010). The model involves an issuer of securities paying the CRA

⁷⁸ The contribution of the CRAs to the cause of the GFC was confirmed by the Group of Twenty (G20) which in April, 2009 declared there was a requirement for "more effective oversight of the activities of Credit Rating Agencies" (Leaders of The G20 2009, p. 6).

for their rating. The ratings, once published are made available to the investors without fees. During the 1970s, CRAs used a 'subscriber pays' model, whereby they generated income by charging the users of the ratings. However, as the issuance of debt securities expanded, the demand for ratings grew commensurately and CRAs discovered it increasingly profitable to charge a fee directly to issuers. "This practice grew to the point where, by 1987, nearly 80% of S&P's revenues came from issuer fees. The balance came from selling research and ratings information to large institutional investors, corporations, and libraries" (Coffee et al. 2010, p. 7).

There are two major reasons for issuers using credit ratings to support their debt securities issues. Firstly, issuers can access a wider investor base as the credit assessment is portrayed as independent and reliable given the assessment is carried out by a third party. Therefore the resultant confidence generated amongst investors, maximises the potential for a fully subscribed issue. Secondly, through the access to the public markets, the issuer may benefit from an improved cost of capital as public debt issues are traditionally less expensive than bank loans. These reasons for using CRAs sustained a continuation of the issuer pays model and contributed to the CRAs ongoing profitability. There was little incentive for CRAs to change business model as observed by Coffee et al. (2010, p.39):

For a variety of reasons, including the shared oligopoly that the major rating agencies enjoy, their virtual immunity from liability, and the conflicts of interest surrounding their common 'issuer pays' business model – the major credit rating agencies simply had too little incentive to get it right.

The question remains then, how did the investment banks that relied on the inflated credit ratings to successfully distribute their securities influence the CRAs to do their bidding?

8.3.1 Coercive Pressure over CRAs from Industry

As arrangers of securities issues, investment banks are often instructed by issuers to negotiate with CRAs on their behalf and arrange for the rating. In this position of influence, and given that ratings agencies often compete with each other for an issuer's rating, there exists a natural arena for influence to be exerted. This influence by an investment bank could be exerted by refusing to contract with a particular CRA unless the investment bank's expectations are met. These expectations could include the price of the rating, the timing of its publication or the level of the rating itself. The investment banking industry is motivated to pursue the highest possible rating for their clients for various reasons. Firstly, there is the reputation factor. If an investment bank is routinely perceived as achieving a higher rating for its client than was expected, this skill would enhance its reputation in the market and therefore potentially attract a greater number of clients seeking to minimise their cost of capital. Secondly, as returns from a security are inextricably linked to the risk and therefore the rating of an investment, there exists arbitrage opportunities when a formal rating is out of step

with the 'true' risk of a security. This infers that the market's view of the risk of a security could differ from the CRAs' view at any given point in time. This can occur as a result of the infrequent and irregular publication of ratings compared to the timely absorption of information by the market in a security's price or the inaccurate rating being issued in the first place.

A rational investor would therefore be motivated to invest in any security whose credit rating is expected to be upgraded within an acceptable time horizon. As the credit rating is upgraded, the return offered in the market is adjusted by way of a price adjustment to reflect the improved credit profile as judged by the CRA. This usually translates into an increase in price, reflecting a premium for a stock or the narrowing of the credit spread for a bond. An investor holding the security would benefit by the instruments price rise in either case. The rational investor would therefore purchase the security in anticipation that the market will adjust its price to the risk commensurate with the CRAs' upgrade of a rating. This behaviour by investors would therefore predispose a preference from the investment community to encourage CRAs to rerate issuers at the top end of the arbitrary band established by the CRAs' rating framework. As investment banks constitute a significant part of the investment community, there is a natural motivation for them to push for these higher re-ratings.

In search of commercial success, S&P was motivated to soliciting feedback from the investment banking industry. The importance placed on feedback from investment banks is illustrated when S&P was developing a new ratings model. S&P had relied on a model known as CDO Evaluator Version 2.4.3 for its rating process involving CDOs. During 2004/2005, this model was subject to review with the intention of improving its functionality and accuracy and the new model was to be known as CDO Evaluator Version 3.0 (E3). The newer model would have produced lower ratings for CDOs and was therefore resisted by senior management at S&P due to the affect it would have on revenue and market share:

The initial update efforts, throughout 2004, were directed in part by the then head of S&P's Global CDO group, whose experience was that the risk of losing transaction revenue was a factor that affected updates of CDO Evaluator ... during the initial update efforts, he and, according to him the then Managing Director in charge of the Cash CDO group, pushed back against updates to CDO Evaluator proposed by one of S&P's senior analysts because they believed these changes would have had a significant negative effect on S&P's market share and ratings business (US Government Department of Justice Office Public Affairs 2015, p. 2).

According to US Government Department of Justice Office Public Affairs (2015), ultimately, given the potential negative impact on existing ratings, the E3 model was postponed. Prior to the intended release of a revised E3 model, S&P sought feedback from investment banks. Emails forwarded internally to senior executives within S&P dated 18th and 19th July 2005, outlined feedback from one of these investment banks. This feedback was noted as follows

in the 'Statement of Facts' forming part of the documents in the case initiated by the US Department of Justice against S&P:

S&P's ratings generated by using CDO Evaluator Version 2.4.3 [this version preceded the proposed new version: E3] had been the 'best' (by comparison to Moody's and Fitch) with respect to CDOs comprised of certain 'more lowly rated' asset pools; S&P would be giving up its market advantage with respect to these CDOs by moving to E3; and S&P would not make up for this with any increase in business in 'the high quality sector' because with respect to this sector Moody's and Fitch can do better than E3 already (US Government Department of Justice Office Public Affairs 2015, p. 2).

Following the opposition to the new model from the investment banking industry, an S&P senior executive stated that:

the roll out of E3 to the market had been 'toned down and slowed down' ... pending further measures to deal with such negative feedback (US Government Department of Justice Office Public Affairs 2015, p. 2).

The investment banks had effectively coerced S&P to cease development of the new version of E3 under the threat of the industry refusing to seek ratings from the CRA given that the new version would result in lower ratings. These sentiments are noted as follows:

the basis for this decision, noting in particular one investment bank's comments that E3 would result in S&P missing potential business opportunities (US Government Department of Justice Office Public Affairs 2015, p. 2).

The above evidence in the 'Statement of Facts' issued by the US Department of Justice demonstrates the coercive institutional influence exerted by the investment banking industry in its feedback relating to the development of a revised ratings model. In effect the pressure from the investment banks ensured that ratings downgrades were kept to a minimum or avoided altogether during that period.

The instinct for generating greater profits at the expense of issuing accurate ratings was also expressed by David Teshler, a Managing Director of S&P, who in March 2007 addressed ratings analysts in directing their approach to future ratings:

Wall Street clients were under pressure to move souring mortgages into new securities called CDOs before the market crashed. Issuers needed the highest grades on the repackaged bonds to sell them to pension funds, banks and other investors (Smith & Ivry 2013).

This message, an example of the pressure placed on ratings analysts to inflate their ratings, is a consequence of coercive pressure. Coercive pressure is more likely and effective on organisations which are financially dependent on one another. For example, sporting organisations who were more reliant on state funding are also more willing to accept the pres-

asures applied by the state to accept change in organisational practice (DiMaggio & Powell 1983; Slack & Hinings 1994).

CRA's relied on investment banks to issue significant volumes of debt securities to sustain their business model. As discussed in section 6.2.1, CDOs and MBS represented a significant amount of total debt securities issued in the pre-GFC period. Representatives from the investment banking industry comprised the major underwriters of these securities and required credit ratings in order to effectively distribute them to their customers. Figure 118 shows the top 12 underwriters of US MBS in 2007. Interestingly LB is the top ranked underwriter based on market share and as a group, the investment banking industry accounted for over 80% of the market share. The industry and LB in particular as the leading underwriter, would have possessed an influential voice in their dealings with the CRA's which helps explain comments by David Tesher.

Figure 118 - Top 12 US Mortgage Backed Securities (including CDOs) Underwriters in 2007

Rank Based on Amount Issued	Investment Bank Arranging Issue	Number of Issues	Market Share Based on Amount Issued*	Amount Issued USD Millions
1	Lehman Brothers	120	10.80%	100,109
2	Bear Stearns	128	9.90%	91,696
3	Morgan Stanley	92	8.20%	75,627
4	JP Morgan Chase	95	7.90%	73,214
5	Credit Suisse	109	7.50%	69,503
6	Bank of America	101	6.80%	62,776
7	Deutsche Bank	85	6.20%	57,337
8	Royal Bank of Scotland Group	74	5.80%	53,352
9	Merrill Lynch	81	5.20%	48,407
10	Goldman Sachs	60	5.10%	47,696
11	Citigroup	95	5.00%	46,754
12	UBS	74	4.30%	39,832

*Note: As other securities firms were involved in arranging MBS issues, the total of market share data does not equal 100%.

Source: The data used for the table was extracted from Coffee et al. (2010, p. 9).

In support of the evidence of undue pressure being exerted internally within S&P, the executive in charge of S&P's RMBS Surveillance Group frequently protested:

that she was prevented by S&P executives from downgrading subprime RMBS as she and the surveillance group wanted because of concern that S&P's rating business would be negatively affected if S&P were to announce severe downgrades (US Government Department of Justice Office Public Affairs 2015, p. 3).

The investment banking industry had successfully exerted its influence over the CRAs and as a result extended the favourable perceptions of the credit profiles of client issuers, thereby facilitating continuing fee generating activity for both the investment banks and the CRAs.

8.3.2 Coercive Pressure over CRAs from Regulatory Requirements

There are numerous examples where credit ratings are included in regulations to guide government authorities in their assessment of an organisation or to restrict investments, in particular investments made by government authorities - these are known as 'regulatory ratings'. Langohr and Langohr (2008) noted that the use of 'regulatory ratings' damages market discipline as there is an artificial bias established by regulation to invest in higher rated issues. Coffee et al. (2010) have criticised the prevalence of regulatory ratings as they tend to defer the responsibility of credit decisions to a third party. "Ratings have become so embedded in guidelines and regulations that the safety judgement of an investment has de facto been outsourced to the CRAs" (Coffee et al. 2010, p. 7). Refer Appendix G for examples of regulations from 1931 to 2000 which required the adoption by US organisations of minimum credit rating thresholds for their investment activities. An example of such a restriction involves the 1991 SEC amendment to rule 2a-7 under the investment company act of 1940 which required US Money Market Mutual Funds to restrict their investments of debt securities to those with a minimum rating of A1 (Coffee et al. 2010).

The minimum rating thresholds indicated in Appendix G had been set by regulators. Therefore, for many investors who were required to invest in rated securities and were bound by the minimum rating standards, their investment universe became limited. An investment universe for these investors needs to meet the regulatory minimum standards and be sufficiently diverse and with a market depth to meet their investment criteria. This creates a natural and skewed demand for higher rated issues - at least equal to or higher than the minimum 'investment grade' band of 'BBB' which is the lowest rating for many of the relevant regulations (Coffee et al. 2010, p. 8).

For an underwritten issue to be successfully placed, the underwriting investment bank's job is made easier if the credit rating of its issuer meets the minimum levels described above. This scenario provides a potential arena for investment banks to exert coercive pressure on the CRAs described in section 8.3.1 to rate an issue which meets the minimum threshold. The CRAs are also under pressure to ensure there is an acceptable volume of issues that meet the minimum, so as to meet the market demand and thereby support their own survival.

The investment banking industry's influence over the CRAs was symptomatic of the self-perception of the industry as a powerful assemblage prepared to exercise its power to

achieve advantageous outcomes. This influence also extended to the successful lobbying of the Financial Accounting Standards Board (FASB) in the development of a key accounting standard - FAS 125 and its successor FAS 140 which was instrumental in the accounting for Repos - a financing tool frequently used by financial institutions and particularly investment banks to assist with their short term liquidity management.

8.4 Institutional Influence over the Accounting Standard Setting Process

This section addresses the influence the investment banking industry applied in the standard setting process for a key accounting standard relating to the accounting of Repos, which are important financing transactions for financial institutions. The influence was analysed using a content analysis which concludes that the accounting standards enabled LB's financial 'window dressing' discussed in CHAPTER 9. The FASB adopts a thorough and independent process for the development and updating of US accounting standards. This process fosters extensive public participation, incorporates views from various stakeholders and is conducted under the supervision of the Financial Accounting Foundation's Board of Trustees. The US accounting standard setting process is outlined in Figure 119.

Figure 119 - Process for Establishment of US Accounting Standards



Source: Information was extracted from Financial Accounting Standards Board (2017).

The consultation stage of the accounting standard setting process may be considered from two main viewpoints. It could be viewed from a technical process, or a political process or both (Larson 2007). Whilst the technical interpretation generally focuses on selecting the most appropriate accounting practice for purpose, the political perspective implies that subjective choices of practices are made between conflicting interests (Larson 2007, p. 214). The consultation process can also be interpreted as an important step in an organisation's attempt in seeking legitimacy (Larson 2007, p. 207). This concept is consistent with Riaz's (2009) notion of reverse legitimisation discussed in section 3.1.3 and again in section 8.4.2 as it relates to the FASB.

Key accounting standards for financial institutions during the decade preceding the GFC included FAS 125 and FAS 140 which both dealt with accounting for transfers and servicing of financial assets and extinguishment of liabilities. FAS 140 which was the accounting standard prevailing at the time of LB's collapse, was adopted by the FASB in September 1999, and effectively replaced FAS 125, however carried over most of its provisions without reconsideration (Financial Accounting Standards Board 2000, p. 4). This standard was important because it guided the accounting treatment for Repos which was one of the main instruments used by LB and the investment banking and securities dealer industries generally. Repos involve a short-term assignment of assets (normally a debt security) to the counterparty in return for cash, thereby creating a funding source for the assignor. The contract also includes a clause requiring the assignor to repurchase the asset at a pre-negotiated price at a pre-determined date in the future (usually between one and two weeks). At that later date (that is at expiry) the counterparty returns the securities to the borrower who repays the cash loan with interest. Refer to CHAPTER 9 which provides a detailed explanation of Repos and describes the relative size and importance of the market.

The differences between FAS 125 and FAS 140 arose principally in the application of the structural tests relating to control over a financial asset and therefore a determination whether a financial asset transfer is deemed a sale (off-balance sheet) or a financing transaction (on-balance sheet). The major difference involved the control criteria over the security being transferred and the rules to determine whether an entity is a Qualifying Special Purpose Entity (QSPE) which is relevant for securitisations and not for Repos. The core provision in FAS 140, which in principle was similar in FAS 125, states that a transferor may only derecognise a financial asset, or a component of a financial asset, if it has surrendered 'control' over it. Under FAS 140:

A transfer of financial assets ... in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange (Financial Accounting Standards Board 2000, pp. 29-30).

The main difference between FAS 125 and FAS 140 relates to the meaning of control. Refer Figure 120 for a list of criteria to satisfy the ‘surrender of control’ requirement under both standards.

Figure 120 - Differences between FAS 125 and FAS 140 Regarding ‘Surrender of Control’

FAS 125 Criteria for ‘Surrender of Control’	FAS 140 Criteria for ‘Surrender of Control’
a. The transferred assets have been isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.	a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right - to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right- free of conditions that constrain them from taking advantage of that right- to pledge or exchange those interests.	b. Each transferee (or, if the transferee is a qualifying SPE, each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable. (Financial Accounting Standards Board 1996a).	c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a clean-up call.

Source: (Financial Accounting Standards Board 1996a, pp. 7-8; 2000, p. 4).

If a Repo transaction fulfils the criteria in both standards then:

the Repo transferor is deemed to have surrendered control of the transferred collateral, and consequently, the respective standards permit the transferor to account for the transaction as a ‘sale’ of financial assets and a forward purchase commitment (Financial Accounting Standards Board 2000, p. 4).

In FAS 140, the control criteria necessary to classify the transaction as a financing, needed the transferor to be:

protected by obtaining collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract so that it has received the means to replace the assets even if the transferee defaults (Financial Accounting Standards Board 2000, p. 91).

This criteria in FAS 140, is only slightly tighter than that contained in FAS 125 which states that “a loss of control applies if there is no agreement that entitles the transferor to repurchase or redeem the transferred assets that are not readily obtainable” (Financial Accounting Standards Board 1996a, pp. 7-8). The meaning of ‘readily obtainable’ in this instance relates to the accessibility to similar assets for repurchase as those that were originally transferred, and relies on the judgement of what is ‘readily obtainable’ or not. For example discretion would be required as to a time frame which would classify an asset as ‘readily’ available for purchase. Although there is a similarity between the definitions in FAS 125 and FAS 140 as they both require ability to transfer and subsequently repurchase similar assets, FAS 140 goes further to require the value of the assets to be repurchased to be substantially equal to the original assets transferred. FAS 140 however, like FAS 125 allows some judgement for the user in determining the quantum of the sufficient value between the transferred asset and that which is subsequently repurchased (Financial Accounting Standards Board 2000, p. 4). An analysis of the influencing factors which came to bear in the formation of FAS 125 which originally allowed flexibility in the interpretation of the accounting treatment of Repos and which was followed by a similar flexibility of interpretation in FAS 140 follows in this chapter.

Section 8.4.10 promotes the case that the investment banking industry and the financial markets industry more generally were strong influential forces in the development of the abovementioned accounting standards. Moreover, LB is found to be an instrumental participant in this process. The influence exerted was intended to create greater flexibility for preparers of financial statements in the accounting and recording of financial asset transfers, and specifically Repos.

The development of FAS 140 is best examined in the context of the FASB's financial instruments project which was initiated in May 1986. Since this project commenced there have been other attempts at refining accounting standards for financial instruments (Financial Accounting Standards Board 2000, pp. 6-9). These recurrent attempts indicate the difficulties and controversies surrounding the fair and reasonable accounting of such instruments. Demand for reform in this area is exemplified, by a Letter from SEC Chief Accountant to the FASB and Accounting Standards Executive Committee (AcSEC) dated May 11, 2001 ‘regarding fair value accounting for the securities industry’ (Securities and Exchange Commission - Office of the Chief Accountant 2001). This letter endorsed the Financial Accounting Standards Board undertaking a project to require the securities industry to adopt fair value accounting for trading and market-making activities (Securities and Exchange Commission -

Office of the Chief Accountant 2001). A chronological outline of the development of significant accounting standards dealing with financial instruments is provided in Figure 121. This chronology highlights the development of FAS 125 and its successor, FAS 140 as important standards dealing with the transfers of financial assets.

Figure 121 - Timeline of US Accounting Standards Dealing with Financial Instruments up to 2000 (Introduction of FAS 140)

Accounting Standard	Implementation Date	Comment
a) FAS 105 b) FAS 107	a) March 1990 b) December 1991	A cursory attempt to address fair value and impairment issues.
a) FAS 114 b) FAS118	a) May 1993 b) October 1994	Required some consistency in assessing and measuring loan impairment. These standards however excluded a market-based valuation method.
FAS 115	May 1993	Recognition that some financial assets should be measured at market values. Established the concept of 'held-to-maturity' important in a financial asset's valuation calculation. It also accepted that some financial assets experienced a temporary decline in value which impacted on the basis of valuation.
FAS 122 (superseded by FAS 140)	May 1995	Required a fair value assessment of capitalised mortgage servicing rights in order to establish an impairment value.
FAS 123	October 1995	Allowed the fair value of stock options issued for executive compensation to be reported as a note to the accounts.
FAS 125	June 1996	Preceded FAS 140 relating to accounting for transfers and servicing of financial assets and extinguishments of liabilities. Specifically covered repurchase agreements.
FAS 133	June 1998	Derivative financial instruments required to be accounted at fair value. Accounting for hedges was allowed to incorporate a smoothing methodology.
FAS 140	September 2000	Superseded FAS 125 and refined the accounting for transfers and servicing of financial assets and extinguishment of liabilities. Specifically covered repurchase agreements.

Source: (Financial Accounting Standards Board 2000, pp. 5-8; Securities and Exchange Commission 2008).

The FASB issued FAS 125 'Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities' in June 1996. Its intention was to provide a consistent standard for distinguishing transfers of financial assets between those that are sales and those that are secured borrowings (Financial Accounting Standards Board 1996a). Examples of these types of transactions include transactions with recourse, Repos, servicing agreements to re-acquire, options, and lodgements of security. FASB was specifically concerned about:

the circumstances under which the transfers of financial assets with continuing involvement should be considered as sales of all or part of the assets or as secured borrowings and about how transferors and transferees should account for sales and secured borrowings (Financial Accounting Standards Board 2006a, p. 6).

Prior to FAS 125, standards for financial assets transferred were generally required to be accounted for by the transferor as "an inseparable unit that had been either entirely sold or entirely retained" (Financial Accounting Standards Board 2006a, p. 8). Those standards caused inconsistencies, were considered to be difficult to implement and provided preparers of financial statements with a significant amount of flexibility in their interpretation (Financial Accounting Standards Board 1996a, p. 7). See below for an explanation of this flexibility. Following the growth in innovative financial products in the 1990s, the FASB concluded:

Previous approaches that viewed each financial asset as an indivisible unit do not provide an appropriate basis for developing consistent and operational standards for dealing with transfers and servicing of financial assets and extinguishments of liabilities. To address those issues adequately and consistently, the Board decided to adopt as the basis for this Statement [FAS 125] a financial-components approach that focuses on control and recognizes that financial assets and liabilities can be divided into a variety of components (Financial Accounting Standards Board 1996a, p. 8).

As mentioned above, previous to FAS 125, the accounting treatment for Repos provided alternative accounting treatments at the discretion of the user (Financial Accounting Standards Board 1996a, pp. 6-7):

For example, whether a transfer purported to be a sale was sufficient to determine whether the transfer was accounted for and reported as a sale of receivables under one accounting standard or as a secured borrowing under another (Financial Accounting Standards Board 1996a, p. 7).

For preparers of financial statements, it could be advantageous to record the transactions as sales and avoid their inclusion in liabilities which would affect leverage ratios. LB's manipulation of its leverage ratios by using the flexibility of interpreting FAS 140 (predecessor to FAS 125) to record its repo transactions as sales instead of debt is shown in Figure 127.

8.4.1 Analysis of Submissions to FASB for FAS 125 and 140

As shown by Figure 119, the process of issuing standards by the FASB involves a consultation process where interested parties invited by the FASB are able to make submissions on the exposure drafts. The key criteria of control featured prominently amongst the submissions (comment letters) within the consultation process for both FAS 125 and FAS 140.

Submissions received by the FASB originated from several different broad interest groups including: representative organisations such as associations (representing the accounting and financial markets industries in particular); participants in the financial markets industry (of which the investment banking industry was prominent); corporations; insurance groups; law firms and academia. Refer Figure 122 and Figure 123 for a breakdown of the industry responses.

Masocha and Weetman (2007) claim attention to the content of documents such as published submissions to exposure drafts, increases the explanatory power of an analysis. An examination of submissions received by the FASB is therefore useful in locating those interested parties who would benefit from having an influence in the standard setting process. Grinyer and Russell (1992) found that parties involved in writing submissions are interested in furthering their economic welfare and that such lobbying influence is able to mitigate the intended purpose of designing accounting standards consistent with accounting concepts. Larson (2007) found that parties lobbying the International Accounting Standards Committee overwhelmingly included large corporations and multinational organisations from developed countries, thereby allowing more powerful organisations that are in a stronger economic position to exert influence. Therefore, categorising authors of submissions and their positions within industry groups is a useful way of identifying any inherent biases introduced into the standard setting process. Section 8.2.2 linked lobbying of regulators and policymakers to favourable outcomes for interest groups such as the investment banking industry. The submission stage in the accounting standard setting process can be considered as a type of lobbying of the FASB in that certain points of view are communicated to decision makers (Georgiou 2004). The following sections use content analysis as a tool to examine two components of the submission process. Firstly, this section analyses the number and weight (as measured by number of pages per industry group) of submissions from the various interested parties grouped by industry. Secondly it addresses the positions taken by the various industry groups on the critical provision within the exposure draft relating to the structural test applying to the accounting treatment of Repos. The structural test is further explained below.

Analysis of Number and Length of Submissions to Exposure Drafts for FAS 125 and FAS 140 by Interest Group

This section undertakes a content analysis of the submissions made by interested parties to the exposure drafts for FAS 125 and FAS 140. The content analysis is conducted on comment letters in response to both exposure drafts which involved analysing 193 submissions containing a total of 1,083 pages. According to Duriau et al. (2007, p. 6), a number of theoretical frameworks, methods and analytical techniques claim to use content analysis in explaining phenomena in the social sciences. A helpful definition of content analysis used in this analysis can be described as : “any methodological measurement applied to text (or other symbolic materials) for social science purposes” (Duriau et al. 2007, p. 6). In their analysis of 98 academic articles using content analysis, Duriau et al. (2007) concluded that this type of analysis is a useful qualitative research tool “in studying both manifest and latent constructs that would be more difficult to access using alternative techniques” (Duriau et al. 2007, p. 26). Content analysis is also used by Holder et al. (2013) to analyse 369 comment letters written in response to exposure drafts issued by the IASB and the FASB's exposure draft relating to FASB Statement No. 5. The content analysis approach used in this section, helps with an understanding of the influences on the accounting standard setting process for the relevant standards and includes an analysis of the submission input as measured by number of submissions and number of pages per submission made by various interest groups and an analysis of the positions taken by various interest groups in their submissions.

As implemented by Larson (2007), when assessing constituent participation in the consultation process adopted by the International Financial Reporting Interpretations Committee (IFRIC) pursuant to its intention to converge international accounting and reporting standards, the proxy used for weight of influence in the standard setting process includes the number of submissions per interest group and the number of pages per submission which indicates the level of consideration assigned by the respective respondent. Submission of comment letters requires significant investment of intellectual capacity, time, and technical resources (Larson 2007; Standish 2003). Analysing the respective percentage of total submissions and percentage of the number of pages submitted by each interest group leads to an understanding of this investment in resources devoted to the relevant topic. The greater the detail incorporated in the submissions as reflected in the number of pages written, generally translates to a greater investment in resources. The greater the number of submissions from a particular interest group is also an indication of the level of interest and applicability of the subject matter contained in the exposure draft to that interest group. The relative importance of the subject matter to each interest group provides an indication of the level of commitment to influencing the process. An analysis of the written content of each submission reveals the particular position taken by each author in relation to the

standard being proposed. Aggregating these positions by interest group, reveals a commonality in the thinking around the proposed standard and signals a self-interest in influencing an outcome beneficial to the interest group (Guenther & Hussein 1995; Kenny & Larson 1993; Kwok & Sharp 2005). The common points of view expressed in the submission letters were sufficient to generate an outcome beneficial to the investment banking industry as discussed in section 8.4.2 and is consistent with a normative influence over a group as to how to behave and adopt a common world view within an industry (Schacter et al. 2011).

An analysis of the industry participation of the submission process for the exposure drafts to FAS 125 and 140 is summarised in Figure 122 and Figure 123 respectively. The method used in compiling this data involved counting the number of submissions per interest group which provided a relative contribution to the total number of submissions received. Additionally the number of pages per author were calculated, which were aggregated by interest group to provide another measure of the weight of each interest groups' submissions. The data in each figure is set out in descending order of percentage of submissions received by the FASB. All publicly available comment letters in response to FASB's consultation request were examined.

A number of law firms' submissions were made on behalf of clients which were in all cases financial institutions. To accurately reflect the number of submissions, each party represented by a law firm's submission has been included separately in the statistics even though the view of all parties included in the law firms' submission letters was the same. The similarity of views in the one submission can be explained by all interested parties sharing a common law firm or by the parties forming a lobby group with the intention of reinforcing a united common position in the hope that it would carry greater weight. The drafting of submissions by a professional law firm, which is governed by its own professional code of conduct, would also convey greater legitimacy to the FASB and therefore represent an attempt to convey a concentrated degree of influence. This manifestation of lobbying constitutes the same type of normative pressures described by DiMaggio and Powell (1983) as a type of social influence leading to commonality. This influence is further discussed in section 8.4.2 in relation to the common views held by the investment banking industry and the FASB.

Figure 122 - Industry Analysis of Submissions to Exposure Draft to FAS 125

Submissions to Exposure Draft for FAS 125 dated 13 January 1997			
Interest Group	% of Total Submissions	% of Total Pages in all Submissions	Average Number of Pages per Submission
Banks and Investment Banks	36%	38%	5.0
Industry Associations	22%	23%	4.7
Non-Bank Financial Institutions	11%	8%	3.2
Other*	9%	11%	20.3
Accounting Firms	8%	11%	6.8
Insurance Companies	7%	5%	3.2
Corporations	7%	4%	2.6
Totals	100%	100%	4.3
	Total Number of Submissions	Total Number of Pages	
	152	719	

*Note: The group titled 'Other' includes law firms, academia, CRAs, and individuals.

Source: The data used for the table was extracted from Financial Accounting Standard Board – Index to submissions for Exposure Draft to FASB Statement Number FAS No. 125, (Financial Accounting Standards Board 1997b).

Figure 123 - Industry Analysis of Submissions to Exposure Draft to FAS 140

Submissions to Exposure Draft for FAS 140 dated 7 December 1999			
Interest Group	% of Total Submissions	% of Total Pages in all Submissions	Average Number of Pages per Submission
Banks and Investment Banks	39%	26%	6.4
Industry Associations	32%	27%	7.5
Accounting Firms	12%	30%	21.6
Non-Bank Financial Institutions	2%	1%	3.0
Corporations	10%	9%	8.5
Insurance Companies	2%	1%	3.0

Submissions to Exposure Draft for FAS 140 dated 7 December 1999			
Interest Group	% of Total Submissions	% of Total Pages in all Submissions	Average Number of Pages per Submission
Other	2%	6%	21.0
Totals	100%	100%	10.1
	Total Number of Submissions	Total Number of Pages	
	41	363	

Source: The data used for the table was extracted from Financial Accounting Standard Board – Index to submissions for Exposure Draft to FASB Statement Number FAS No. 140, (Financial Accounting Standards Board 1999a).

Figure 122 and Figure 123 categorise respondents to the exposure drafts by interest group. This is intended to gauge the weight of influence on the standard setting process by the different groups. Although banks and investment banks, and non-bank financial institutions are separate categories, they represent the financial market community which are the largest combined group that uses Repos. The following analysis therefore combines these two categories under one group, ‘financial institutions’. As Figure 122 and Figure 123 clearly show, the financial institutions group as a whole submitted the greatest number of submissions for exposure drafts on FAS 125 and FAS 140 representing 47% and 41% respectively of all submissions. The volume of submissions as measured by number of pages was also dominated by the financial institutions group for FAS 125 representing 46% of total number of pages received. However for FAS 140, the same group accounted for 27% of total pages ranking equally second (with industry associations) slightly behind accounting firms, which submitted 30% of total pages. (Financial Accounting Standards Board 1997b, 1999a). It is notable according to Figure 122 and Figure 123, that FAS 125 attracted a larger number of submissions than FAS 140. The attention from industry towards FAS 125 may be due to it being the first standard introducing a more prescriptive treatment of accounting for all transfers and servicing of financial assets and extinguishments of liabilities. FAS 140 merely represented a minor revision of the same standard, without significantly altering the notion of ‘control’ (Financial Accounting Standards Board 2000).

As the industry group mostly affected by FAS 125 and FAS 140, it is not surprising that the financial institutions group in aggregate for both exposure drafts, accounted for the greatest number of submissions (44%) which also contained the most content (37%) from submissions made by any other group. Through their representation in the process, the financial institutions group were clearly interested in the formulation of the standards and desired to have an influence in the final outcome.

Analysis of Positions Taken by Respondents to Exposure Draft to FAS 125

This section analyses the positions taken by interest groups regarding the content of FAS 125. The analysis conducted relates to the exposure draft for FAS 125 only as it diverged significantly from the previous accounting standard, FAS 115 dealing with transactions similar to Repos. Commentary on the exposure draft for FAS 140 is therefore excluded as the fundamental accounting treatment for Repos under both FAS 125 and FAS 140 remained largely unchanged. The analysis on FAS 125 focuses on the component of the exposure draft dealing with Repos. FAS 125 also covered related topics dealing with securitisations and other derivatives which are excluded from this content analysis in view of their irrelevance to the subject of Repos. This approach isolates the influence over the standard affecting Repos consistent with the argument in this section that certain financial institutions preferred a greater flexibility in interpreting the accounting treatment as either an on-balance sheet liability or a sale.

Figure 124 - Position Analysis of Submission Letters to Exposure Draft on FAS 125

Group	Reject Exposure Draft	Support Exposure Draft	No Comments	Reject Exposure Draft but with Recommendations	Total By Group
	(a)	(b)	(c)	(d)	
	Number of Submissions	Number of Submissions	Number of Submissions	Number of Submissions	
Banks and Investment Banks	22	0	3	11	36
Non-Bank Financial Institutions	6	0	12	6	24
Industry Associations	12	1	1	5	19
Industrial Corporations	0	2	7	1	10
Insurance Companies	4	2	0	4	10
Accounting Firms	2	1	0	4	7
Other	3	1	2	1	7
Total	49	7	25	32	113

Source: Financial Accounting Standard Board – Submission Letters to Exposure Draft to FAS No. 125, (Financial Accounting Standards Board 1996b).

An analysis of the positions taken by interest groups in relation to the exposure draft for FAS 125 appears in Figure 124. The list is organised in ranking by 'total by group' column. This analysis identifies four categories of responses: (a) a rejection of the exposure draft, with respondents preferring the prevailing accounting treatment; (b) support for the exposure

draft; (c) no comments relating to the Repo component of the exposure draft; and (d) a rejection of the exposure draft with recommendations for an alternative approach. Column (d) combines two main alternative approaches: a risk reward approach which allocates accounting treatments for transactions according to the risks and rewards assigned to each party to the transaction; and an approach which accounts for transactions based on their economic substance. The latter recommendation is similar to the risk reward approach as the economic approach entails an accounting treatment commensurate to the financial benefits which accrue to the respective parties in the transaction and is justification for aggregating responses which support the two approaches in the one column.

The main focus by respondents to the exposure draft relating to Repos contained in FAS 125 involved their preference for the classification of Repo transactions as either borrowings – in which case responses would be included in column (b) or an acceptance of the ‘90-day bright-line test’ (refer below) which inferred either a borrowing or sales treatment – in which cases responses were included in column (a). The prevailing accounting standards dealing with these types of transactions allowed classification based on the intent of the parties. This allowed a high degree of discretion for participants in Repo transactions to interpret the accounting treatment. Refer to CHAPTER 9 which discusses in detail the interpretation issue relating to FAS 125 and FAS 140 which both allowed entities to account for Repos as sales as opposed to borrowings.

The exposure draft attempted to change the notion of intent to a structural test known as the ‘90-day bright-line test’. This prescriptive test defined whether a Repo would be classified as either a sale or a borrowing based on the maturity of the Repo. Repos which had maturities over 90 days were classified as a sale whilst Repos which had maturities less than 90 days were categorised as ‘assuredly temporary’ and classified as a secured borrowing. (Financial Accounting Standards Board 1997a). Figure 124 clearly shows that 94% of submissions received rejected the prescriptive nature of the ‘90-day bright-line test’. It is clear that preparers of financial statements including financial institutions and their representative bodies (mostly comprising associations of financial institutions and accounting firms) favoured a non-prescriptive approach to classifying Repos and to preserve their freedom to use a subjective measure under the prevailing accounting standards. Further, no banks and investment banks were in support of the exposure draft, with 61% preferring the status quo.

LB's Influence in the Accounting Standard Setting Process

The submissions for FAS 125 included a letter submitted by LB and signed by its CFO, David Goldfarb. LB acknowledges in its submission that it also worked with the Public Securities Association (PSA)⁷⁹ in drafting its response to the exposure draft and fully supported the association's position (Goldfarb 1996, p. 1).

The PSA is the predecessor association to The Bond Market Association (TBMA), which subsequently merged with the Securities Industry Association (SIA) to form the Securities Industry and Financial Markets Association (SIFMA). The PSA was the professional representative body for the international bond market industry, accounting for 44% of the global securities market (The Association for Financial Markets in Europe 2015). The merged PSA/TBMA⁸⁰ which was headquartered in New York and had offices in London and Washington represented a diverse mix of securities firms and banks. The merged PSA/TBMA was considered one of the most important lobby groups representing the investment banking industry and regularly participated in debates relating to the development of the bond industry on behalf of issuers and traders. (Securities Industry and Financial Markets Association 2015).

An analysis of the submission letters to the Exposure Draft for FAS 125 was conducted to discover any joint submissions and in particular whether comment letters which were submitted by industry associations and investment banks were co-authored or acknowledged a joint approach. The analysis revealed no other investment banks acknowledged they had worked with an industry association or the PSA in the preparation of the PSA submission (DeRoma & Guba 1995; Financial Accounting Standards Board 1996b). Therefore LB was in a unique position to influence the PSA's view on the exposure draft. In fact, submissions for

⁷⁹ The Public Securities Association was incorporated in 1976, and underwent a name change to the Bond Market Association in 1997 to better reflect its broadened constituency and membership.

⁸⁰ "The Bond Market Association, previously Public Securities Association or PSA until 1997 was the international trade association for the bond market industry. It had headquarters in New York City and offices in London and Washington, D.C. Twenty per cent of the membership was located outside the US, while 70 per cent was located outside New York City. TBMA acted as a global voice for bond issuers and traders, and worked with governments, corporations, and investors. It also had a code of ethics, which required members to behave in a fashion of fairness. On November 1, 2006, The Bond Market Association merged with the Securities Industry Association to form the Securities Industry and Financial Markets Association" (Securities Industry and Financial Markets Association 2016).

both LB and PSA appear similar and proffer the same arguments relating to Repos (DeRoma & Guba 1995; Financial Accounting Standards Board 1996b; Goldfarb 1996). This suggests that LB was either in agreement with the PSA, or one of the parties had an influence over the other's position on the exposure draft. If LB was influencing the PSA, it was in a position to exert an even greater power over the standard setting process than had it relied on its own submission without collaborating with the PSA. As the representative body of the global bond markets, the PSA's view would have been interpreted as representing the views of the bond market in general and therefore carried added weight.

LB's essential objection to the exposure draft for FAS 125 related to the 90-day bright-line test'. LB claimed in its submission to the FASB that the 90-day bright-line test does not ...

... Reflect the economic substance of these transactions. The 90-day bright-line test of assuredly temporary is an arbitrary distinction with no underlying basis in either the structure or intent of the transaction. We are not aware of shortcomings in how secured financings are currently reported or treated in the accounting literature from either a financial statement preparer's or user's perspective, and hence we do not see any logical reason to change the present accounting model (Goldfarb 1996, p. 1).

The strong prescriptive nature of the exposure draft for FAS 125 did not allow preparers of financial statements to have the arbitrary benefits and flexibility of alternative accounting treatments afforded by the previous accounting standard which was predicated on intent rather than a list of prescriptive criteria. The artificial distinction based on time period for a Repo being classified as either a sale or a financing was the key prescriptive criteria proposed by the exposure draft and was objectionable to many other parties who made submissions to the FASB. Refer above for an analysis of the positions of respondents to the exposure draft. LB (and the PSA in its submission) clearly favoured the previously existing standard advising in their submission that they "are not aware of shortcomings in how secured financings are currently reported" and "do not see any logical reason to change present accounting model" (Goldfarb 1996, p.1).

Ultimately the FASB succumbed to the recommendations contained in the submissions - predominantly from financial market industry participants - and removed the 90-day bright-line test of 'assuredly temporary' from the final accounting standard FAS 125 leaving preparers of financial statements to interpret the accounting treatment of Repos dependent on the notion whether control of the securities had passed or not. In its background discussion contained in FAS 140, the FASB outlined its rationale of omitting the '90-day Bright-line test' as a response to the overwhelming position held by respondents to the exposure draft for FAS 125. The FASB supported its reversal from the initial draft as follows:

Respondents generally disagreed with that provision of the Exposure Draft of Statement 125. They argued that the arbitrary three-month limit would not be effective and that entities could alter the accounting for a transfer by adding or subtracting one or two days to or from

the term of the agreement. While some offered other arbitrary time limits, many respondents argued that all transfers accompanied by a forward contract to repurchase the transferred assets before maturity should be accounted for as secured borrowings. In their view, most repurchase agreements represent a temporary transfer of only some elements of control over the transferred assets.

After considering those comments, the Board decided to remove the proposed requirement that the period until repurchase be less than three months. Board members concluded that any distinction based on the specified time until repurchase would not be workable. As outlined in paragraph 207, the elements of control by the transferee over assets obtained in a typical securities lending or repurchase agreement are both temporary and limited. The Board concluded that the contractual obligation and right to repurchase an asset before its maturity effectively bind the asset transferred back to the transferor (Financial Accounting Standards Board 2000, p. 89).

Instead of the '90-day Bright-line test' the FASB established the 'surrender of control' requirement for a Repo to constitute a sale, and listed three key criteria for its determination including:

- a) The transferred asset being isolated from the transferor;*
- b) The transferee obtaining a right (free of conditions) to pledge or exchange the transferred asset or exchange the transferred asset; and*
- c) The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (Financial Accounting Standards Board 1996a, p. 4).*

The industry participants were ultimately successful in lobbying the FASB to change the exposure draft so as to improve the flexibility of the accounting standard for preparers of financial statements. The implications were that LB acquired greater power to interpret the standard, thereby allowing it to interpret the standard to the advantage of the firm.

8.4.2 Objection to Exposure Draft an Exercise of Institutional Influence

The proposal presented in the exposure draft to FAS 125 of limiting the flexibility of options in the accounting treatment for Repos may be perceived by LB and other financial institutions as placing a limitation on their power to represent the firm through their financial statements to external stakeholders. Bradbury (2007) acknowledges that accounting standards subject to interpretations signal a weakness and have the potential to undermine a principles-based approach. Submissions to exposure drafts document the interpretation

process and participation in the standard setting process. Therefore, in accordance with the findings of Georgiou (2004), submissions can be viewed as a representation of lobbying efforts to which the standard setter is subjected. Westbrook (2013, p. 58) claims that in modern society, “we have a financial culture that consists largely of communications about relative social standing defined by a dubious system of accounting”. If we measure the status of an organisation by the strength of its financial statements then there is an inherent motivation for the same organisations to influence the system of accounting in their favour. The ability to influence the accounting standard setting process is made easier by a cultural bias which naturally affects the standard setters. As standard setters need to know a lot about accounting, and in most cases employed by the accounting and finance industry, they are by definition “within the culture they seek to regulate” Westbrook (2013, p. 58).

Young and Mouck (1996, p. 133) argue that:

the close mirroring of the FASB processes with those of administrative agencies may be interpreted as an effort to construct these processes as rational and objective and thereby to reduce the politics surrounding the accounting standard setting process.

In the course of pursuing its rules and procedures in the accounting standard setting process, the FASB attempts to avoid critique and claims of bias. The carefully constructed consultation and review process adopted by the FASB is purposefully followed to emphasise the appearance of independence and objectivity and to distance itself from any perception that the FASB establishes public policy or is in any way political. This is because being categorised as political infers that decisions are made as a “manipulative and emotional process in which favours were [are] traded” (Young & Mouck 1996, p. 134). Excessive claims of objectivity may be intended by the FASB to manage perceptions that its decision-making represent a universal perspective (Young 2003; Young & Mouck 1996). Having established in the previous section that the financial markets industry would be motivated to influence the accounting standard setting process in its favour, and the fallibility of the process itself where the accounting standards guardians, the FASB, are susceptible to possible political influence and bias, then how is this industry influence conveyed?

New Institutional Theory is helpful in explaining the exertion by industry and submission by the FASB to the influence in the accounting standard setting process. Three concepts are at play in this process: firstly the normative pressures exerted on the FASB by industry in general; secondly the reverse legitimisation sought by the FASB and thirdly a subtle coercive pressure exerted by the industry over the FASB. The FASB and the accounting industry (including organisations which are compelled to apply accounting standards) need to be understood in terms of one another, mutually rather than confrontationally. A suitable metaphor used by Westbrook (2013) to describe this notion is that of a referee of a game who represents the institution. In this analogy the referee is the FASB. “A referee does not exist without the game. Conversely, games cannot be won without a set of conventions to de-

termine the bounds of the field, what counts as a point and the like” (Westbrook 2013, p. 58). Similarly, the FASB cannot exist without the practitioners and corporations who apply the rules. Conversely, those relying on financial statements, whether they are users or preparers, without a ‘referee’ cannot benefit from consistencies, rigour and discipline provided by the application of those standards. This mutual reliance between the standard setter and the practitioner is an important aspect of the relationship which incubates a culture of similarity and commonality. As mentioned in section 3.1 of this thesis, the normative pressures described by DiMaggio and Powell (1983) is a type of social influence leading to commonality. The notion described earlier that the FASB is “within the culture they seek to regulate” (Westbrook 2013, p. 58) and therefore subject to a natural bias, supports the contention of a common world view within a profession. This common view construes professionalism by members collectively and defines the appropriate ways in which to behave and act.

The FASB, the members of which originate from the accounting and finance profession, is subject to these same pressures of accepting institutional norms, which can be conveyed through the instrument of the submission letters. Since the standard setters and the practitioners are members of the same professional community, they are able to collectively determine a set of practices and cognitive frameworks in which organisational routines are shaped. This type of normative pressure is heightened particularly if a large volume of submissions are conveying the same recommendation.

The second concept which allows the conveyance of influence is that of reverse legitimisation. As discussed in section 3.1.3, Riaz (2009) contends that if organisations such as investment banks are successful, the institutions such as the FASB from which organisations and practitioners sought legitimacy, are endorsed as the responsible entities which supported those successful organisations and practitioners under their authority. For reverse legitimisation to exist, industry participants would be expected to support the FASB as long as its standards are valuable to those participants. This is consistent with the concept that the involvement of industry participants in the consultation process through the writing of comment letters is an important factor in imparting legitimacy on the standard setting process and in turn the supervisors of this process – the FASB (Durocher et al. 2007; Fogarty 1992; Larson 2002; Olusegun Wallace 1990). The case for reverse legitimisation is also contingent on the power of the industry participants and their willingness to manipulate entities and processes that interfere with their primary objectives. Riaz (2009, p. 28) recognises this latent power of financial institutions:

Business and financial organizations today are powerful beyond imagination, and have a role in influencing, shaping and manipulating anything that happens to be in the way of their survival and success. And what else could be more ‘in their way’ than institutions? While institutions attempt to impose their constraints on organizations, organizations are busy twisting the iron cage inside-out over the institutions.

The interdependence between institutions such as the FASB and the organisations and practitioners who rely on accounting standards allows for the transferral of influence both ways. The perception of power held by practitioners which is used to influence the institutions that oversee them is influenced by which side of the 'iron mesh' the power is viewed (Riaz 2009, p. 28).

The FASB was keen to deeply and carefully consult the financial markets industry, given the subject of the proposed accounting standard was considered highly technical. Without a thorough consultation process, the new standard may have had unintended consequences. The FASB therefore canvassed a high number of industry participants as evidenced by the number of organisations invited by the FASB to comment on the exposure drafts. The number of responses to direct invitations totalled 152 (including several respondents represented by single law firms who were counted separately) and 41 for FAS 125 and FAS 140 respectively. Submissions highlighted some unintended consequences from the 90-day bright-line test. The main problems identified by industry practitioners related to the artificiality of the 90-day Bright-line test. The 90-day Bright-line test was to determine whether a financial instrument transfer could be deemed a sale or a financing simply by its term to maturity. This was a misalignment of the planned recording of the transaction with its intention or its economic substance.

The third concept of a subtle coercive pressure is demonstrated through the enthusiasm of the financial institutions to appear in front of the FASB during direct hearings over the exposure draft to FAS 125 to declare their views and recommendations. According to Financial Accounting Standards Board (1996b), there were 60 respondents (representing almost 40% out of a total of 152 parties who made submissions), who spoke at public hearings for the exposure draft to FAS 125. There were no respondents (out of a total of 41 parties who made submissions) for the exposure draft to FAS 140 (Financial Accounting Standards Board 1999a). As mentioned previously the relative disinterest in FAS 140 was due to the relatively minor amendments it incorporated.

As discussed in section 3.1.3, coercive pressures may take various forms and be disguised or restrained. Although it may resemble exercise of force or persuasion, it may also be more subtle (Devin & Bartlett 2011, p. 5). Further, coercive pressures may result from power relations that come in various forms, formally or informally, directly or indirectly, from externally codified rules, norms or laws, from political influence and from a variety of external entities.

The subtle coercive pressure over the FASB to follow the wishes of the financial markets industry in their opposition to the 90-day Bright-line test can be interpreted as a political influence. The influence was derived from the overwhelming number of participants who in addition to forwarding documentary submissions, contributed in the direct hearings that followed. The option to appear in person was at the discretion of the respondent and their

attendance was successful in extending their influence even further given the omission of the 90-day Bright-line test from FAS 125.

Tolbert and Zucker (1983, p. 25) suggest that an indicator of institutionalised practice includes a “practice that is widely followed, without debate, and exhibits permanence”. The actions of the financial markets industry represented a concerted and largely unified effort to influence the FASB and in this regard resembled a widely followed view. The respondent presentations at the FASB hearings were seemingly accepted without a significant debate given the absence of further documented commentary by the FASB on the exposure draft to FASB 125. Finally, given the recommended compliance required by accounting standards in general and the acceptance by practitioners that they represent the rules that govern their practice, there appears a sense of permanency to the resolutions of the FASB. Therefore Tolbert & Zucker’s (1983) indicators of institutionalised practice seem to have been satisfied. In meeting Tolbert & Zucker’s (1983) indicators of institutionalised practice, as well as representing DiMaggio & Powell’s (1983) normative pressures and subtle coercive influence over the FASB, and finally fulfilling Riaz’s (2009) characterisation of reverse legitimacy, the financial markets industry, in dealing with the exposure draft to FAS 125 exerted influence over the FASB in shaping a critical accounting standard to the advantage of the industry as a whole during the pre-GFC period.

8.5 Summary

This chapter is concerned with the role of connections and relationships in influencing outcomes favourable to the investment banking industry. It commenced with a discussion of the ‘financial network’ that existed which encompassed the investment banking industry, the political and regulatory fields, CRAs, lobby groups, and other financial institutions. It is argued that the connections with these participants in the ‘financial network’ led to: a ‘regulatory capture’ by the investment banking industry which influenced the regulatory process to produce an environment conducive to generating stronger financial performance; influence over the CRAs which published favourable yet flawed credit ratings for customers of the investment banks and the firm sponsored securitisation vehicles; and influence over the accounting standard setters which through a consultation process involving the investment banking industry issued an accounting standard – FAS 140 which allowed LB the flexibility to avoid the accounting of Repos as debt, thereby allowing a ‘window dressing’ of its financial statements.

The investment banking industry was found to have exerted coercive pressure on legislators which was facilitated through a combination of their political contributions which are part of a system entrenched in the US political arena and the use of their extensive use of lobbying

in shifting public policy. It was used to either defeat unwanted bills which would have otherwise further restricted the activities of investment banks or the passing of bills which afforded further protection or greater liberalisation in their operating environment. The 'regulatory capture' of legislators and regulators by the investment banking industry was also facilitated by a normative influence found to exist due to knowledge asymmetry. The possession of superior technical capability exerted a normative influence over the regulatory framework by the investment banking industry. The subjugation by regulators to industry professionals of the expertise required to understand innovations in product, process and complex risk, led to a regulator's perception that 'industry knows best'. This perception allowed a continuation of a 'light touch' approach to financial regulation. A further normative influence was exerted over the regulatory framework due to the practice of the 'revolving door'. As members of professions employed in the financial network switched between regulatory agencies, legislative bodies and industry, a common view of the world which included the regulatory framework ensued. Common values and beliefs permeated an increasingly intertwined financial network so that a common understanding and attitude existed to sustain a regulatory environment and economic policy setting conducive to favourable business conditions in the investment banking industry. A common desire for strong financial performance by investment banks spurred a common approach to the employment of lobbyists to push a shared agenda. Mimetic pressure also spurred investment banks to pursue relationships with government with the intent of a continued stream of large and lucrative government funding and advisory transactions. These connections were useful for future business and as an instrument in pushing a point of view with government and regulators.

The investment banking industry was also found to exert coercive influence over the CRAs by way of their commercial support. The CRAs preference for an issuer pays model introduced inherent conflicts of interest. The influence was principally exerted by an investment bank's threat of withdrawing the commercial support from the CRAs which operated in a competitive environment. A loss of market share, particularly for securitisation vehicles arranged by their sponsoring investment banks would mean a loss of potential income for the CRAs. The relationship between the two groups also involved a consultation process as investment banks were sought to provide direct feedback to CRAs on the credit rating models employed. The industry feedback enabled investment banks to influence the model development process which ultimately produced the most desirable outcomes for the issuers they represented. However inadvertently the regulatory framework was structured, it also influenced inflated ratings.

Finally the chapter explored the influences the investment banking industry applied over the FASB in attempts to generate accounting standards favourable to preparers of financial statements involved in accounting for Repos. A content analysis was conducted of comment letters covering exposure drafts for FAS 125 and FAS 140 which involved analysing 193 submissions containing a total of 1,083 pages. This analysis revealed a concerted effort by the

investment banking industry to exert an institutional influence over the FASB by objecting to the original exposure draft resulting in an accounting standard favoured by the industry. The benefits of avoiding a highly prescriptive accounting standard as originally proposed by the FASB in the exposure draft allowed for greater flexibility in the treatment of Repo transactions. LB was able to capitalise on this flexibility by accounting for Repos as sale transactions instead of borrowings. This accounting treatment led to an understatement of the firm's leverage ratio and ensured the continued supply of credit during a period of financial distress. CHAPTER 9 further explains Repo 105 in detail and analyses the power exerted by LB's senior management in ensuring the interpretative use of accounting for this financial instrument achieved the desired effect of concealing significant levels of its debt.

CHAPTER 9 **FINANCIAL ‘WINDOW DRESSING’ AS AN EXERCISE OF POWER**

This chapter includes a discussion of the ‘window dressing’ practiced by LB to conceal a substantial level of debt from external stakeholders. This deceptive practice, identified as a symptom of the firm’s culture, is exposed as an exercise of power to ensure the continued survival of the firm. This strategy was considered important to maintain the perception that LB was financially sound which was necessary to secure continued funding for the firm. Sufficient capital was also necessary to meet compliance with financial covenants contained within debt agreements and capital based regulations. Additionally capital and an acceptable balance sheet structure was necessary to maintain an acceptable credit rating from the CRA’s which is also important for future fundraising.

A key to satisfying financial stakeholders, was to ensure the firm’s financial statements reflected an ongoing financially sound position. An immediate concern was the firm’s liquidity and financial leverage – key metrics popularly used in financial covenants within debt agreements and used by the credit rating agencies as important determinants of financial strength. Generally finance was sourced directly from banks, a high proportion of which was short term in nature including short term money market instruments mostly comprising of Repos. Refer 7.3.1 for a discussion on the financing arrangements of LB. A soundly structured balance sheet was crucial to avoid concerns by creditors who could otherwise decline additional credit, cancel unused credit facilities, refuse to roll-over existing lines of credit or ultimately, demand repayment of outstanding debt. Given financial institutions typically rely on relatively high levels of leverage, any such consequence would be catastrophic and potentially lead to severe financial difficulties.

Therefore LB’s management desperately believed they needed to present an acceptable financial structure. This would pressure senior management to consider a ‘window dressing’ of the financial statements if there were concerns of a weak financial position. Valukas (2010) acknowledged management’s focus on leverage and identified a number of staff who confirmed that LB management was actively engaged in managing the firm’s leverage towards the end of 2007 and early 2008:

Tonucci recalled that McDade wanted to bring down Lehman’s firm-wide balance sheet by a few turns ... McDade, who was named balance sheet czar, said that deleveraging was ‘absolutely’ a critical issue to Lehman in early 2008 ... Ed Grieb, Lehman’s former Global Financial Controller, stated that ‘the focus on balance sheet and net leverage gained much more importance’ beginning in mid-2007 ... Murtaza Bhallo, Business/Risk Manager in Proprietary Trading Group for Liquid Markets, said that

beginning in 2007, there was a 'squeeze' on Lehman's balance sheet, and that Lehman personnel were worried about reporting the level of Lehman's assets against Lehman's equity (i.e., leverage ratio) ... Anuraj Bismal, a former Senior Vice President in Lehman's Balance Sheet Group, said that Lehman's meeting of its leverage ratio target was the most critical piece (a very hot topic) for senior management by the end of 2007. Bismal said that balance sheet targets and leverage ratio targets were absolutely about how rating agencies would view Lehman, and also creditors and the investing public ... John Feraca, the former head of the Secured Funding Desk in Lehman's Prime Services group, said that in late 2007, as the industry was changing and entering a crisis period, Lehman made certain commitments to deleverage ... Marie Stewart, Lehman's former Global Head of Accounting Policy, confirmed that Lehman set balance sheet targets with any eye to reaching certain leverage ratios that rating agencies used to measure and gauge Lehman's performance (Valukas 2010, pp. 808-9).

An analysis of the relatively high and increasing levels of leverage of the investment banking industry and LB is included in section 7.3.1. This chapter delves further however, and explains one of the techniques used by LB in creating its excessive leverage leading to the benefits accrued under the 'leverage effect'. Section 8.4 discussed the influence exerted on accounting standard setters by the investment banking industry to preserve the flexibility in their accounting treatment of Repos. FAS 140, the applicable accounting standard for Repos allowed investment banks to employ divergent interpretations of the standard which permitted LB's 'window dressing' of its financial statements. More importantly this chapter questions why and how Fuld and his management team made the decisions to use these accounting techniques.

9.1 Repo 105 Transactions

A Repo 105 transaction is a variety of a Repo transaction. The added term of '105' in a Repo 105 is explained in detail in section 9.1.2. Repos generally involve a short-term assignment of assets (normally a debt security) to the counterparty in return for cash, thereby creating a funding source for the assignor. The contract also includes a clause requiring the assignor to repurchase the asset at a pre-negotiated price at a pre-determined date in the future (usually between one and two weeks). At that later date (that is at expiry) the counterparty returns the securities to the borrower who repays the cash loan with interest. Refer Figure 125 for a diagrammatical representation of a Repo 105.

In the lead up to its collapse, LB attempted to stave off a liquidity crisis and became increasingly reliant on the use of Repos for its short term borrowings. Repos are an important financing technique in the financial markets, in particular for securities firms, investment

banks and commercial banks. “The ability of Repos to provide parties with secured short-term funding has resulted in such transactions becoming an essential part of the global financial system” (Chircop et al. 2012, p. 657). Much of the Repo market uses US Treasury securities as the preferred form of collateral, as they represent government obligations and are therefore one of the most secure and liquid security instruments in the market. Other instruments are used in a Repo transaction such as corporate debt securities and stocks. The Repo market is also the most important financing market of the short term money market for dealers, the main participants of which are securities firms and investment banks. The Repo market represented approximately 54% of the pre-GFC inter-dealer short term money market using US Treasury instruments (Fleming & Garbade 2003, p. 1). The reliance on the Repo market for short term financing is reflected by its volume of transactions of approximately USD 14 trillion in 2008 (Chircop et al. 2012, p. 661). This represents a significant increase from 2002 when the volume was USD 2.48 trillion (Fleming & Garbade 2003, p. 1).

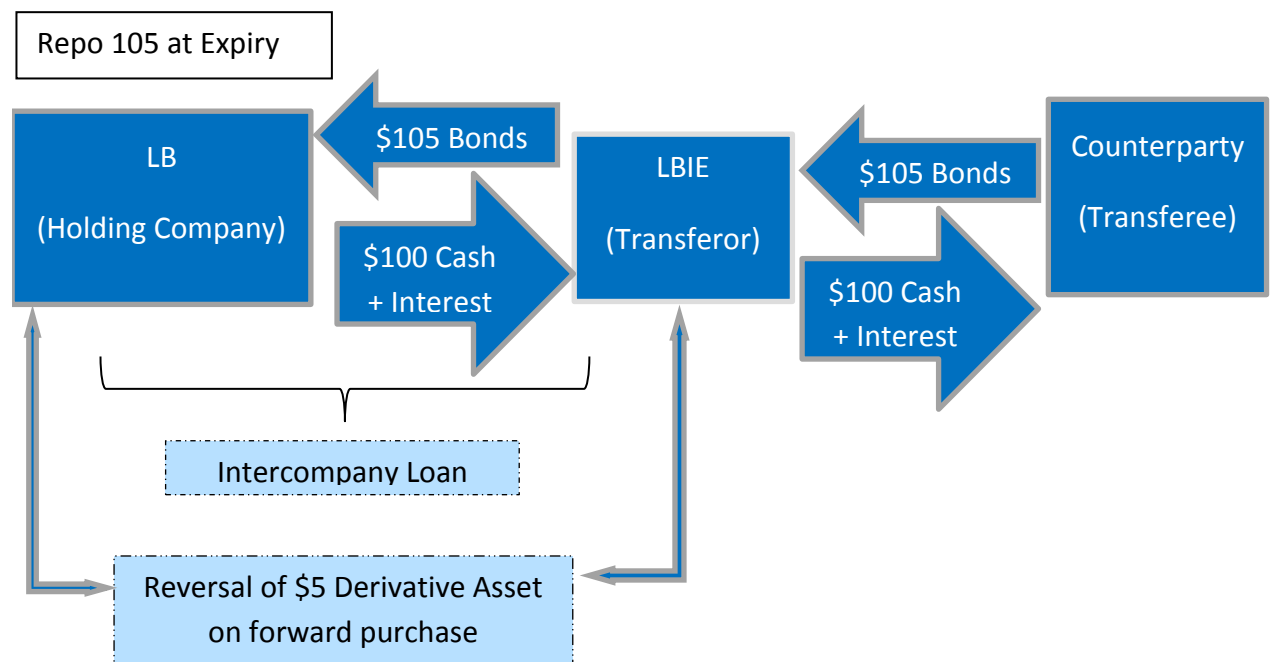
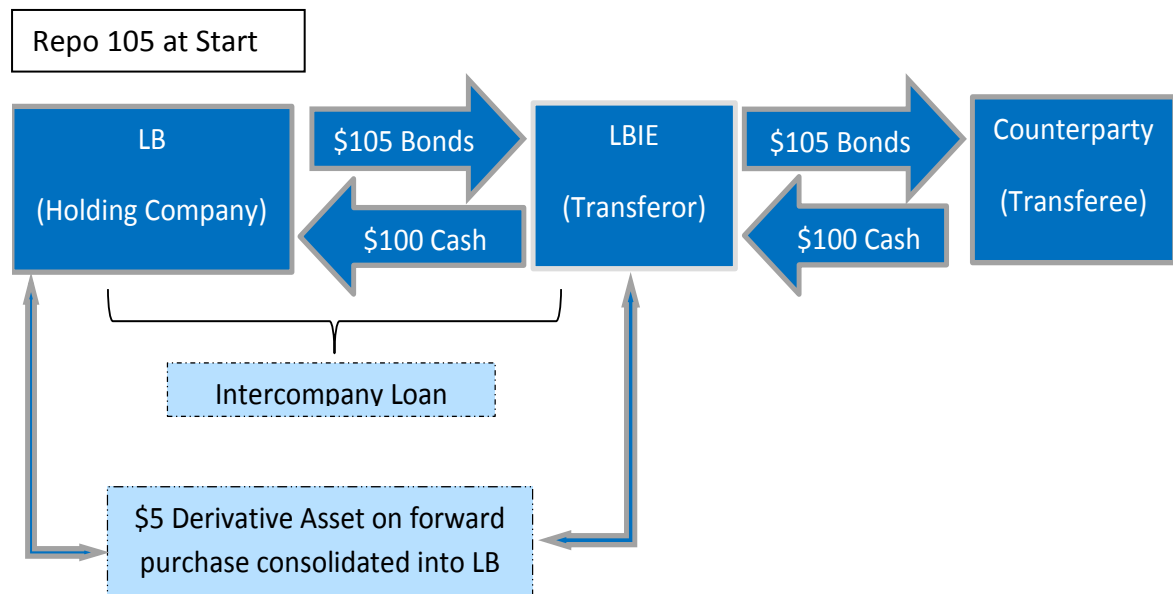
According to the bankruptcy examiner, LB understated its leverage through the use of a particular type of Repo referred to as ‘Repo 105’ transaction, an accounting exercise to temporarily reduce liabilities from the balance sheet before each reporting period. Refer below in this section and section 9.1.2 for a detailed explanation of a Repo 105 transaction and the method employed to reduce balance sheet liabilities. LB’s global financial controller, described the transactions as possessing “no substance - their only purpose or motive ... was reduction in the balance sheet” (Financial Crisis Enquiry Commission 2011, p. 177).

Repo 105 transactions were also portrayed as an “accounting gimmick ... a lazy way of managing the balance sheet as opposed to legitimately meeting balance sheet targets at quarter-end” (Financial Crisis Enquiry Commission 2011, p. 177). Bart McDade, LB President and COO in June 2008, described Repo 105 transactions as “another drug we R on” (Financial Crisis Enquiry Commission 2011, p. 177). This comment related to the increasing reliance LB had on the continuing use of Repo 105 transactions to decrease liabilities in turn reducing the leverage ratio for each successive quarter end. Furthermore “McDade had recommended to LB’s Executive Committee that the firm set a cap on the use of Repo 105 transactions” (Financial Crisis Enquiry Commission 2011, pp. 3-4). A senior member of LB’s Finance Group also believed that LB’s Repo 105 transactions were designed for “window-dressing that was based on legal technicalities” (Financial Crisis Enquiry Commission 2011, p. 2).

9.1.1 Offshoring and impact of LB’s Repo 105 Transactions

A diagrammatical representation of a Repo 105 transaction undertaken by LB is set out in Figure 125:

Figure 125 - Repo 105 Transaction



In Figure 125 the assignor, or commonly known as the transferor or borrower, is depicted as Lehman Brothers International (Europe) (LBIE UK). LB used a European subsidiary to conduct Repo 105 transactions as legal opinions for the accounting treatment adopted by LB were only able to be obtained under English law in the UK. LB was unable to find a US law firm prepared to grant a 'true sale' opinion under US law. See section 9.2 titled 'Linklater's True Sale Opinion Letter' for a discussion on the legal opinion. Repo 105 transactions were essentially equal in nature to standard Repo's, however the accounting treatment for the former was decisively different. Despite the different accounting treatment used for Repo 105 transactions, LB executed the same documentation as that used for ordinary Repos.

LB applied a sales treatment to the assets assigned under a Repo 105 transaction under FAS 140. This is contrary to the typical accounting treatment for an ordinary Repo transaction which raises a liability on account of the transferor (borrower) for the amount of the transaction, collateralised by the inventory of securities pledged to the Repo lender with the securities which were used as collateral remaining on the transferor's (borrower's) balance sheet. This liability would be subsequently extinguished on expiry when the transferor (borrower) repays the loan and the transferee (lender) returns the collateral.

Repo 105 transactions on the other hand effectively enabled LB (the transferor/borrower) to remove the loan off-balance sheet during the term of the Repo 105 transaction. This was achieved by applying the incoming cash from the transferee (lender) to repay liabilities on LB's balance sheet and applying the transfer of securities to the transferee as a reduction of on-balance sheet assets, and recording the asset transfer as a sale. Under this treatment there would be an equal reduction in both total liabilities and total assets. This 'typical' practice by LB resulted in obfuscating additional debt sourced through the Repo 105 transaction, and the equal reduction in total assets and liabilities had the effect of improving the leverage and capital ratios. The accounting entries for a Repo 105 transaction are set out in Figure 126.

Figure 126 - Accounting Entries for a Repo 105 Transaction ¹

Accounting Entries for Repo 105		
At Start (pre-balance date)		
	<u>Debit</u>	<u>Credit</u>
Sale of Securities		
Cash (received from sale)	100	
Future Purchase Account- Inventory (Derivative Asset)	5	
Securities Inventory (reduction)		105
Net	105	105
Use of Proceeds		
Liabilities (repayment)	100	
Cash		100
Net	100	100

At Expiry (post-balance date)		
	<u>Debit</u>	<u>Credit</u>
Raising Cash to Repay Repo 105		
Liabilities (new borrowings)		105
Cash (to repay transferee/lender)	105	
Net	105	105
Repaying Repo 105		
Securities Inventory (repurchase of securities)	105	
Future Purchase Account- Inventory Derivative (asset)		5
Profit and Loss ²	0.5	
Cash		100.5
Net	105.5	105.5

Notes:

1. The accounting treatment used in Figure 126 is confirmed by examples used in (Rajan 2010).
2. Assumed equivalent to interest expense for period of transaction.

A demonstration of the impact of Repo 105 is set out in Figure 127. Two key financial ratios (leverage and capital ratios) are calculated using the two accounting treatments available, that is, 'with' and 'without' the Repo 105 accounting application. The results are shown for the 2007 annual balance sheet date and the quarterly balance sheet dates, 29 February 2008 and 31 May 2008.

Figure 127 - Comparison of LB's key balance sheet ratios 'With' and 'Without' Repo 105

30-Nov-07					
		Without Repo 105		With Repo 105	
		USD Billions	%	USD Billions	%
Total Assets		729.2	100%	691.1	100%
Total Liabilities		707.2	97%	668.6	97%
Total Stockholders' Funds		22.5	3%	22.5	3%
Leverage Ratio (times)		31.4		29.7	
Capital Ratio (%)		3.09%		3.26%	

29-Feb-08					
	Without Repo 105		With Repo 105		
	USD Billions	%	USD Billions	%	
Total Assets	835.1	100%	786	100%	
Total Liabilities	810.3	97%	761.2	97%	
Total Stockholders' Funds	24.8	3%	24.8	3%	
Leverage Ratio (times)	32.7		30.7		
Capital Ratio (%)	2.97%		3.16%		

31-May-08					
	Without Repo 105		With Repo 105		
	USD Billions	%	USD Billions	%	
Total Assets	689.8	100%	639.4	100%	
Total Liabilities	663.5	96%	613.1	96%	
Total Stockholders' Funds	26.3	4%	26.3	4%	
Leverage Ratio (times)	25.2		23.3		
Capital Ratio (%)	3.81%		4.11%		

Note:

Leverage Ratio = Total Liabilities / Total Stockholders' Funds

Capital Ratio = Total Stockholders' Funds / Total Assets

LB reported the figures in the 'With Repo 105' column.

Source: The data used for the table was extracted from LB's annual and quarterly financial statements and information contained in the Chapter 11 Proceedings Examiner Report, (Lehman Brothers Holdings 2007, 2008b, 2008c; Valukas 2010).

Figure 127 shows there is no material difference in Total Stockholders' Funds and Total Liabilities in proportion to Total Assets in either accounting applications. The leverage and capital ratios however vary depending on the accounting treatment used. The use of the Repo 105 accounting treatment consistently produced more favourable ratios for each of the balance sheet dates shown above. LB did not include any detailed disclosure of the accounting impact of using Repo 105 in its financial reporting. A key consideration for LB as to whether it would disclose this accounting treatment would have been whether the Repo 105 application would materially affect the financial statements. If the use of the Repo 105 accounting treatment was considered immaterial, then detailed disclosure would not be needed in accordance with Generally Accepted Accounting Principles (GAAP). It could be argued that there was no change in the proportion of total liabilities to total assets between accounting treatments, both recording 96% for the balance sheet dates of 30 November, 2007 and 29 February 2008, increasing slightly to 97% as at 31 May 2008. In any case interim financial statements are not audited. However, the impact of the Repo 105 accounting treatment could be deemed material if measured by its sheer nominal dollar amount. LB had at one

point borrowed up to USD 50 billion in Repo 105 transactions just prior to its collapse. Refer below for details of the amounts involved in Repo 105 transactions.

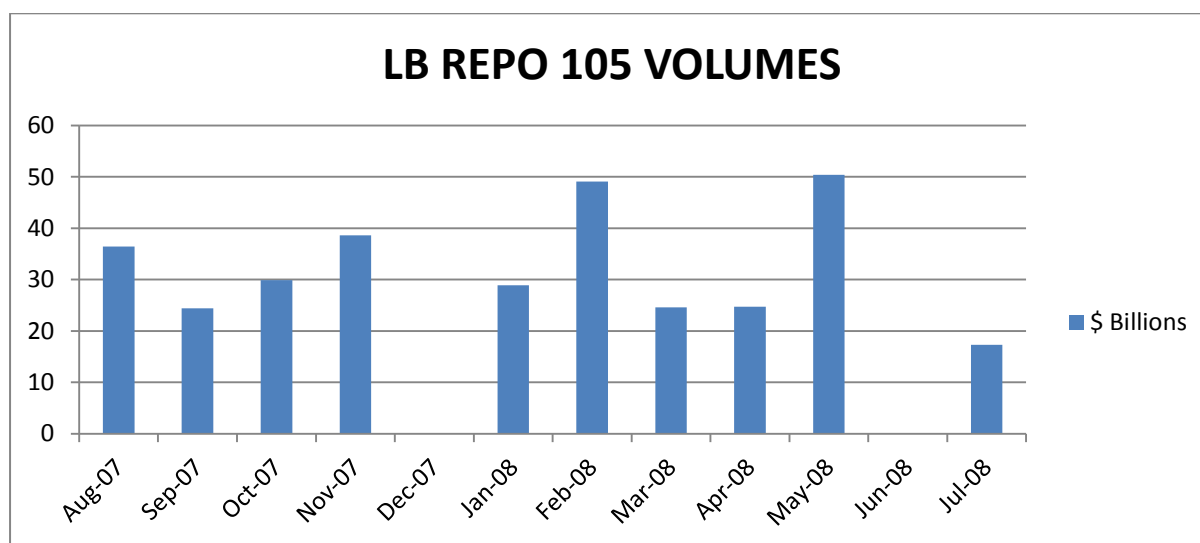
Although the differences in key ratios between the 'with' and 'without' repo 105 accounting treatment appear small, they are deemed meaningful due to the very low capitalisation of LB. The relatively low capitalisation of the investment banking industry in general magnifies the net impact on capital when compared to other industrial corporations whose capitalisation rates are generally higher. Additionally, the capital and leverage ratios are commonly used measures in credit assessments of borrowing entities. It would have been advantageous for LB to use the Repo 105 accounting treatment in order to present a more favourable financial profile to its creditors.

As mentioned in section 8.4 the core provision of FAS 125 and later FAS 140 states that a transferor may only derecognise a financial asset, or a component of a financial asset, if it has surrendered 'control' over it. Under FAS 140:

A transfer of financial assets . . . in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange (Financial Accounting Standards Board 2000, p. 4).

The conditions to be met for an effective 'surrender of control' of the assets under FAS 140, is set out in section 8.4. LB interpreted that under FAS 140, it had surrendered control of the assets, rendering the exchange of assets for cash as a sale and accordingly removed the asset (securities), and the amount exchanged off its balance sheet. However given that the securities transferred to the transferee (lender) were effectively used as collateral for financing purposes and to be returned to LB (the borrower) at maturity, it is argued in this thesis that LB did not relinquish control over the collateral and continued to retain a 'beneficial interest'. LB's reclassification of a Repo 105 transaction as a sale immediately led to an understating of LB's leverage ratio. LB had borrowed, in aggregate, over USD 50 billion by using Repo 105 and temporarily reduced its on-balance sheet debt and corresponding assets at quarter end by approximately: USD 38.6 billion in the fourth quarter 2007; USD 49.1 billion in first quarter 2008; and USD 50.38 billion in the second quarter 2008 (Valukas 2010, p. 733). Refer Figure 128 for a graph of the volumes of Repo 105 transactions undertaken in the 12 months preceding the bankruptcy.

Figure 128 - LB use of Repo 105 Transactions 2007 - 2008



Source: The data used for the graph was extracted from Valukas (2010, p. 733).

Importantly, Figure 128 shows this balance sheet manipulation occurred prior to quarter end dates (in particular November 2007, February 2008 and May 2008) in line with the firm's quarterly reporting obligations. As a result, LB's net leverage was understated by between 9% and 13% between fourth quarter 2007 and second quarter 2008.

9.1.2 What does '105' mean?

The term '105' in a Repo 105 transaction signifies that upon exchange, assets (in the form of securities) transferred have a current market value of 105% of the cash received. The term 'haircut' often used in Repo 105 transaction refers to the difference between the amount of cash received and the market value of securities assigned. Therefore in a Repo 105 transaction the haircut is 5%.

The FASB defines effective control as follows:

to maintain effective control, the transferor must have both the contractual right and the contractual obligation to reacquire securities that are identical to or substantially the same [in quantum] as those concurrently transferred ... the transferor's right to repurchase is not assured unless it is protected by obtaining collateral sufficient to fund substantially all of the cost of purchasing identical replacement securities during the term of the contract (Financial Accounting Standards Board 2000, p. 91).

As an example, if the transferor is giving up securities worth USD 105 in return for cash worth USD 100 (in ratio terms), LB would be able to argue that it could not meet the requirements of FAS 140 of "reacquiring securities that are identical to or substantially the

same [in quantum] as those concurrently transferred” (Financial Accounting Standards Board 2000, p. 91). The discrepancy between the value of securities transferred and the amount of cash received (that is, 5%) was the justification used by LB to argue the loss of control criteria. Therefore LB was able to argue a ‘loss of control’ over the securities and consequently able to record the leg of the transaction involving the assignment of collateral as a sales transaction which did not need the raising of a liability. Otherwise, without this treatment as a ‘sale’ LB would have been required to treat the assignment of collateral and receipt of cash as a loan. Although in its guidance notes, FAS 140 suggests a haircut of 2% was sufficient to render loss of control (commonly referred to as the 98%-102% test) (Financial Accounting Standards Board 2000, p. 97), LB ensured it qualified for the ‘sale’ interpretation by applying a higher haircut of 5%. LB offered more collateral in a Repo 105 transaction than is normally necessary for a standard Repo, to ensure it unequivocally achieved the off-balance sheet treatment for the debt.

It is interesting to note these sales did not give rise to any losses in LB’s statement of income. It would be common accounting practice for a sale transaction involving exchanging USD 105 in bonds for USD 100 in cash to record a USD 5 loss. LB however used a future purchase commitment account in its asset section of its balance sheet equal to the amount of over collateralisation, since LB was required to purchase the sold securities back under a futures contract. Similar to an ordinary Repo, LB received the interest income (the coupon payments) from the securities which were transferred to the counterparty which partly offset the interest charged by the counterparty which was paid by LB at expiry of the transaction (Valukas 2010, p. 732). Furthermore LB decided not to disclose the effect of these transactions as recognised subsequent events in the notes to the accounts based on their view that it represented an immaterial consequence to the firm’s financial statements as explained in section 9.1.1.

Implementation of FAS 140 had been problematic given that it allowed alternative treatments of Repo transactions depending on how loss of control is substantiated. A loss of control threshold (for example between 2% and 5%) allowed an entity to de-recognise the asset and whilst continuing to have ‘beneficial interest’ subsequent to it being transferred. Further, allowing de-recognition, while at the same time allowing the transferor to retain an effective continuing ‘beneficial interest’ in the transferred financial asset, permitted for varying accounting treatments between the two parties to the transaction.

9.2 Linklaters’ True Sale Opinion Letter

LB validated the sale treatment of its Repo 105 transactions by obtaining a legal opinion. Apart from the haircut mentioned above, another criteria used to substantiate the notion of

‘surrender of control’ of the transferred asset included isolating the securities from the transferor in the event of the transferor’s bankruptcy.

The legal opinion is ordinarily referred to as a true sale opinion letter. LB resorted to obtaining its legal opinion from Linklaters, a UK law firm. Linklaters would address the legal opinion to LB’s UK subsidiary – LBIE which was the LB subsidiary that entered into the Repo 105 transactions. LB resorted to using a UK law firm as it could not find a US law firm prepared to issue an opinion to a US entity. In its accounting policy relating to Repo 105 transactions, LB discloses that: “We generally cannot obtain a true sale opinion under US law ... Repos generally cannot be treated as sales in the US because lawyers cannot provide a true sale opinion under US law” (Lehman Brothers Holdings 2008e, p. 1). To avoid any potential breach, the Linklaters true sale opinion letter did not refer to US GAAP or FAS 140.

In practice, the UK subsidiary would carry out a Repo 105 transaction with an external European counterparty (including the haircut) and concurrently carry out a back to back transaction with a LB US subsidiary (excluding the haircut). As LBIE was a fully owned subsidiary of LB, the transactions were ultimately consolidated into the group financial statements giving effect to the sale treatment at the consolidated group level, thereby ameliorating the group leverage ratio.

In essence LB was able to conduct regulatory arbitrage by exploiting the UK legal environment which allowed ‘true sale’ opinions and by subsequently consolidating the resultant accounting treatment into its US based consolidated financial statements. This was a practice, which if conducted within the US would have resulted in a less than favourable accounting treatment with regards leverage. Undertaking such an elaborate and pre-meditated process is an indication of the extent to which LB was motivated to manipulate its balance sheet structure to manage the perceptions of stakeholders. Details of Repo 105 transactions were not disclosed in LB’s Form 10-K or 10-Q financial reports resulting in an effective window dressing of the net leverage of the firm. Since the collapse of LB, the FASB introduced FAS 166, which superseded FAS 140. This revised accounting standard applies a test based on the intent behind a Repo in relation to transfers of risk for reward to distinguish between a sale or on-balance sheet treatment of a Repo.

9.3 Concealment as Power

LB’s concealment of debt from its financial statements withheld critical information with which third parties would make important financial decisions, such as to invest or lend to LB. An internal email from Anthony Jawad, an LB employee to Keiran Higgins another LB employee, intimated a degree of apprehension regarding LB’s accounting treatment of Repo

105 transactions. The email revealed that internally, employees questioned the accounting treatment adopted:

Hello mate, sorry to pester you on your time off, but I have to run this by you. In our quest for more counterparties for 105, we have lined up Reserve Bank of Australia as a c/party. This is good from a credit perspective because credit will obviously be happier giving margin to a Central bank than a commercial bank. However, they asked why we are doing this. I spoke to Mark Cosaitis about this and he obviously would like us to give a vague reason about getting better net down treatment, which isn't a lie. However, if they want a deeper explanation then we may have to get down to the nitty gritty of the truth. Do you want us to go down this line or want us to just give it a miss. Having more c/parties is obviously good going forward because we both know how liquidity can be pulled, but the more people that know the truth, the more dodgy it can be. What is your take on what to do? Thanks (Jawad 2008).

The routine practice of using the Repo 105 accounting device is governed internally by inclusion in the LB accounting manual. The power to influence stakeholder decision-making is viewed as an exercise of power through Clegg's (1989) dispositional circuit where rules and pre-determined procedures, as contained in the accounting manual, are fixed. The existence of the accounting manual as well as the Linklaters' 'true sale opinion' legitimised the accounting treatment of Repo 105 transactions for all employees. The accounting manual represented the rules of practice which were socially constructed within the firm. Therefore it represented the instrument which fixed the relations of meaning, in an accounting sense of the Repo transactions. These internally constructed rules [accounting manual] are used to affect the accounting entries which are considered the passage point through which the Repo transactions were integrated within the financial statements. Once transmitted through the passage point, management's power was exerted over external stakeholders in the episodic circuit where stakeholders' perceptions of management and the firm were positively influenced through the manipulation of the firm's risk profile.

The development of the accounting manual, through the firm's hierarchy, was the responsibility of the executive management. This responsibility and the associated authority, was the source of power for LB's executive management. The senior team relied on the accounting standard, FAS 140 which allowed for alternative accounting interpretations of Repo 105 transactions resulting in meaningful implications for the balance sheet. The use of the internal accounting manual, can also be seen as an act of job design found in Clegg's (1989) facilitative circuit. The use of job design was useful in applying power through internal relationships between senior management and those accounting practitioners within the firm whose responsibility was to record the Repo transactions. FAS 140 had facilitated senior management's concealment of leverage and the internal technical interpretation of this standard as guided by the LB accounting manual legitimised the accounting treatment.

This level of power in the facilitative circuit affected the organisational morality as evidenced in the abovementioned email from Anthony Jawad. Any influence over the operation of the accounting standard translated as an exertion of power over accounting staff permitting the distortions in the financial statements. Was the senior management team culpable for the concealment? In his statement at the Hearing before the Committee on Financial Services, Fuld denied any knowledge of the Repo 105 series of transactions:

I have absolutely no recollection whatsoever of hearing anything about or seeing documents related to Repo 105 transactions while I was the CEO of Lehman (Hearing before the Committee on Financial Services U.S. House of Representatives Testatement of Richard Fuld 2010).

Fuld's abovementioned denial contradicted evidence offered by McDade to the Bankruptcy Examiner's proceedings. In his role as COO in the months prior to LB's bankruptcy, McDade had responsibility for the firm's balance sheet. A report known as the Daily Balance Sheet and Disclosure Scorecard which kept senior management abreast of daily balance sheet movements was distributed by McDade on a daily basis in the 6 months prior to the bankruptcy. Amongst other data, the report included information on the firm's Repo 105 transactions (Valukas 2010). According to Valukas (2010), an interview with McDade revealed that in June 2008, he reviewed with Fuld, an internal document known as the Balance Sheet and Key Disclosures document:

McDade specifically walked Fuld through the presentation. . . . McDade discussed page three of the presentation with Fuld, which identified that Lehman used USD 38.6 billion, USD 49.1 billion, and USD 50.3 billion of Repo 105 transactions, at quarters-end fourth quarter 2007, first quarter 2008, and second quarter 2008, respectively. McDade said that, as referenced on page three of the Balance Sheet and Key Disclosures document, he also told Fuld that he [McDade] recommended that Lehman reduce its firm-wide Repo 105 usage to USD 25 billion in the third quarter 2008. McDade observed that Fuld 'was familiar with the term 'Repo 105'. McDade recalled that Fuld's response to the entire document was 'good, good, good; he was nodding approval' and that Fuld was 'supportive of reducing the firm's use of Repo 105.' More specifically, regarding McDade's recommendation to cut Lehman's use of Repo 105 in half in the third quarter 2008, McDade recalled Fuld asked, 'Is it doable? Is it necessary? If so, [Fuld] said, go do it.' McDade concluded that Fuld knew about the accounting of Repo 105 (Valukas 2010, pp. 820-1).

The inconsistency between Fuld's testimony at the 2010 hearing before the Committee on Financial Services and McDade's detailed record of interview with the Bankruptcy Examiner casts significant doubt on the veracity of Fuld's testimony. The overwhelming evidence obtained by the bankruptcy examiner supported by documentary evidence, suggested that Fuld was willing to mislead the Committee on Financial Services in 2010, thereby casting even greater doubt over his integrity.

9.3.1 The Irony of Power – Disempowerment in the Facilitative Circuit

Figure 128 shows an increasing volume of Repo 105 transactions at the quarterly reporting dates from August 2007 to May 2008. Continuing use of Repo 105 during a period when market liquidity is tightening and the firm's access to internal cash resources is diminishing means the firm needed to continue refinancing these transactions at higher volumes each successive quarter end to maintain the façade of acceptable leverage. Unless the firm's performance was going to turn around, eventually its excessive leverage would be discovered as interest serviceability would become strained. Reliance on Repo 105 therefore became a vital component to LB's survival during this time. As the actual leverage of the firm increased, there was greater incentive to disguise it.

Fuld's resolve in maintaining the firm's use of Repo 105 during this difficult period which involved its unethical interpretation of FAS 140 can be interpreted as a turning point in his empowerment. The slippery slope of Repo 105 on which the firm began its concealment program could not persist indefinitely. As the risk of discovery approached, Fuld's capacity to 'fool' the market diminished. This gradual slide is tantamount to an ongoing disempowerment, where Fuld's economic environment and the firm's fiscal predicament are considered changes in Clegg's (1989) facilitative circuit where power can be created or dissipated through changes in environmental contingencies. As the firm's financial dependency on Repo 105 grows, its bankruptcy costs⁸¹ grow commensurately. The power to convince creditors to continue refinancing debt is therefore diminished. The passage point needed for the disempowerment is represented by the potential discovery of the firm's real position through media such as closer scrutiny of the firm's financial transactions, analysis of finan-

⁸¹ Bankruptcy costs are additional costs incurred by the firm as its leverage increases. These costs take two major forms. Firstly there is the increased cost of capital as interest costs increase in line with mounting debt. This affects the profitability and financial structure of the balance sheet of the firm thereby perpetuating an increase in the risk premium paid as the debt is now riskier to the lender. Secondly as management attention is drawn away from the day to day operational matters of the business to managing the survival of the firm, performance can deteriorate further.

cial reports, or media speculation. The irony of the creation of power is that in certain environmental contingencies it can also be taken away through the same circuit of power.

9.4 SUMMARY

The concealment of a significant level of debt from the firm's balance sheet is shown to be an unethical practice of 'window dressing' which violates an ethical stewardship of the firm and disguised a 'true and fair' economic view of LB's financial position. The firm adopted extreme measures to achieve the debt concealment by its interpretation of accounting standard FAS 140 to its benefit which understated its leverage. The measures involved the conducting of Repo 105 transactions through offshore subsidiaries and obtaining the associated legal opinions from an offshore jurisdiction, when they were unavailable domestically.

The act of debt concealment is argued as an exercise of power found in Clegg's (1989) facilitative and dispositional circuits. The accounting rules which were authorised by management were fixed in the dispositional circuit, transmitted through the passage points constituting the accounting function to the episodic circuit where external perceptions of management and the firm were influenced. The development of the accounting manual, an ultimate responsibility of management conferred power to Fuld by way of defining the accounting staff's job design thereby creating power in Clegg's (1989) facilitative circuit which affected organisational morality. The same passage point of the accounting function served to transmit power to the episodic circuit where accounting staff were pressured to adopt the 'sale' interpretation of FAS 140. LB's interpretation and application of FAS 140 to account for and report Repo 105 transactions was authorised and perpetuated by LB's senior management and was used to legitimise the firm as creditworthy, a going concern and compliant with applicable contractual covenants and capital based regulations. In summary, LB's senior management exercised power to influence the growth strategy of the firm involving an elevation of its risk profile in expectation of greater individual rewards in the form of incentive compensation. The following chapter analyses the management style adopted by Richard Fuld in his day to day stewardship of LB. The chapter will also draw on a theme of power to explain Fuld's motivation of self-interest. Ultimately Fuld's objectives to grow the firm in terms of size and profit gave way to a desire for survival at all costs.

CHAPTER 10 **MANAGEMENT STYLE AND FIRM CULTURE**

10.1 Introduction

This chapter addresses the research question regarding the extent to which the culture within LB and the investment banking industry contributed to the failure of many firms at the height of the GFC. It analyses LB's CEO, Richard Fuld's management style, the actions of the board and the organisational culture which emanated from the top. The methods used to explain these factors include an examination of the rhetoric used in the communications of the firm and a critical analysis of: the corporate governance framework; the firm's management processes, organisational policies; key internal relationships and; the CEOs and board's decisions and behavioural patterns.

Section 10.2 discusses the impact on corporate culture of corporate governance with a focus on board structure, including the difficulty of defining it. Corporate governance is an important aspect of ensuring appropriate behaviour is exhibited throughout the organisation – an attribute this chapter will show to be lacking at LB. Literature covering the benefits of the features traditionally considered as corporate governance good practice⁸², have offered some mixed views. Therefore an analysis against all the benchmarks offered by traditional conventions of good practice to measure LB's governance practices may prove incomplete. Instead, this section selects the factors considered relevant in LB's case and focuses on the leadership of the firm. This section also covers the adoption by the US of a regulatory approach as a minimum standard for corporate governance, following a series of corporate failures in the early part of the 2000s. The minimum standards set by the regulations be-

⁸² Traditional features of corporate governance best practice focusing on board structure, as summarised to include: "director qualification standards; director responsibilities; director access to management and, as necessary, appropriate, independent advisors; director compensation; director orientation and continuing education; management succession; annual performance evaluation of the Board" (New York Stock Exchange 2014 - 303A.09).

came the framework by which LB portrayed to the outside its adoption of good practice, regardless of its effectiveness.

Section 10.2.4 deals with LB's board structure and compares it to that of Goldman Sachs, one of the more successful investment banks⁸³. The comparison suggests that investment banks attempted to comply with regulations and official guidelines to represent proper conduct to the market. This approach of uniform compliance is also augmented by some commonality in certain board structure features, which suggests a normative institutional influence applied between certain investment banks. Despite the similarity in Board structure, the two firms performed quite differently. That is, whilst LB collapsed, Goldman Sachs survived. This incongruity reveals the existence of other underlying influence(s) apart from the superficial Board structure which affected the performance of LB.

Section 10.3 examines features of board structure as key factors influencing LB's culture and performance. These features include the relationship between Fuld and the Board of Directors, which was typified by the exercise of intermittent power. This power was exerted through: the process of Board member appointment, in which Fuld had an influence; the Board composition which was structured to minimise confrontation with Fuld's aspirations; the background and experience of some Board members which lacked specific exposure to complex investment banking products and services; a deficient level of director engagement reflected by the composition of the various Board committees and the relative input from each committee to the decision-making at Board level; and, a generous Board compensation structure which was influenced by Fuld and exceeded the national average of members of US publicly listed Boards and ranked above most of the other major US investment banks.

Section 10.4 investigates Fuld's relationships with employees. It draws on the early influences on Fuld's management style which is described as one driven by his motivation to generate growth for the firm and succeed at all costs. As demonstrated by examples, any employee who offered obstacles or resistance to this objective would suffer his scorn, or

⁸³ Goldman Sachs is selected as a comparison as it was the only investment bank surviving the GFC in its original form. As mentioned in CHAPTER 2, Bear Sterns was forced to merge with JP Morgan Chase given both firms' financial difficulties, and Merrill Lynch & Co. which encountered similar difficulties was sold to Bank of America Corp. Morgan Stanley survived in its corporate form, however it closed its trading division because it contributed large losses to the firm during the GFC.

worse still, dismissal. Fuld's influence in overcoming these impediments is shown to be generated in Clegg's (1989) dispositional and episodic circuits. The resulting culture also affected the families of employees, which served to entrench employees' behaviours to fall within the CEO's expectations. LB's compensation arrangements discussed in section 10.5 are also scrutinised to reveal a 'greed-centric' attitude amongst many executives who were subject to LB's incentive schemes. It explains the role of compensation as a motivation for employee behaviour and as a mechanism to maximise the wealth of senior management including Fuld. This section proposes that the CEO used financial incentives as a means of generating loyalty to pursue his own growth agenda.

A further insight into the firm's culture included in section 10.6 is achieved through a rhetorical analysis of internal communications. Key documents such as the firm's *Global Strategy* document and various internal emails are analysed to reveal a management style reliant on the centralisation of power, a siege mentality, hubris regarding the risks faced by the firm, and a perpetuation of the 'greed centric' culture. Finally section 10.7 questions whether the firm followed its published code of ethics.

10.2 Corporate Governance

The lack of effective corporate governance has been linked as a causal factor of the GFC (Aluchna 2013; Isaksson & Woodside 2016; Kennedy 2014; Yeoh 2010). Yeoh (2010) relies on observations of relevant banking practices to support this contention. Therefore this section provides a critique of relevant factors of corporate governance in the context of the pre-GFC period in the US, and the impact it had on the failure of LB. A large component of CEOs and a Board's role is to practice, oversee and engender good corporate governance. In a general sense, good governance can be thought of as how individuals, groups, organisations, societies, and governments are responsible for outcomes and ethical behaviours (Pitsis et al. 2014, p. 1287). Cadbury (1992 p. 15) defines corporate governance as "the system by which companies are directed and controlled". This latter definition aligns responsibility for corporate outcomes closer to the leadership of the firm. However corporate governance is difficult to define as the associated literature adopts different theoretical perspectives. These include for example agency, stewardship, resource dependency and stakeholder theories (Chambers et al. 2012).

Corporate governance can be viewed from an agency perspective (Cadbury 1992 ; Denis 2001; Fama & Jensen 1983; Jensen & Meckling 1976; Shleifer & Vishny 1997). That is, "effective separation between ownership and control" (Shleifer & Vishny 1997, p. 738). The basis of agency theory is maximisation of stockholder wealth. This longstanding theory traces its origins to the paper by Berle and Means (1934), which represents a seminal publication

soon after the onset of the financial crisis of the 1930s. Berle and Means (1934) evaluated the financial crisis in the context of the evolution of the modern corporation and the concept of “the twin phenomenon of ownership of wealth without appreciable control and control of wealth without appreciable ownership” (Lewis 1935, p. 548). Fama and Jensen (1983) argue that the process of operational decision-making is the responsibility of senior management and should be separated from the process of consent and monitoring which is undertaken by Boards of Directors. This separation, according to Fama and Jensen (1983), ensures an effective monitoring of the organisation’s decision-making process. As Boards have the ability to structure the compensation arrangements of a CEO, and limit his or her tenure, they possess the ultimate power in the decision-making process.

Jensen and Meckling (1976) claim that tension exists between management and stockholders and view management as being opportunistic. Referred to as the ‘agency problem’⁸⁴, management are motivated by self-interest as they don’t always make decisions based on the economic interests of stockholders (Deegan 2009; Jensen & Meckling 1976). The agency approach supported by Fama and Jensen (1983) who maintain that a key to solving this agency problem and creating an effective monitoring process is the inclusion of non-executive directors on boards and board committees to protect the interests of stockholders. This is achieved through the impartiality of non-executive directors who can provide an independent check on management decision-making and behaviour. Apart from their impartiality, non-executive directors can offer specific expertise that is not available within the organisation and arbitrate in cases of internal conflict. The alternative approaches to understanding corporate governance are listed in the following section, including a brief critique of the agency theory approach.

10.2.1 Alternative Approaches to Corporate Governance

Most research attempting to understand the motivational forces influencing the range of decisions within the corporate sector have used agency theory and the role played by CEO compensation structures (Jensen & Meckling 1976; Haugen & Senbet 1981; Smith & Stulz

⁸⁴ An agency problem exists when the interests of management and / or Board members are not aligned with those of stockholders. Any misalignment potentially affects the primary corporate goal of maximising stockholder wealth.

1985; and Guay 1999). Agency theory describes the conflicts that arise under conditions of incomplete and asymmetric information when a principal hires an agent, such as the problem that the principal and the agent may not have their interests aligned. Literature addressing agency theory is mostly shareholder-centric, addressing potential adverse impacts on shareholders from management decision making. It therefore ignores other key relationships, both internal and external to the firm. Shareholder interest is the paramount concern of agency theory.

Critics of agency theory also claim that it understates the complexity of individual motivations and organisations. Agency theory, which focuses on self-interested human behaviour has come under challenge (Perrow 1986; Weidenbaum & Jensen 1992). Weidenbaum and Jensen (1992) supported by Shughart (1996), concur that “it is foolish to believe that owners of valuable resources systematically relinquish control to managers who are not guided to serve their interest” (Weidenbaum & Jensen 1992, p. 102). Weidenbaum and Jensen (1992) offer a critique of Berle and Means (1934) and argue that the concept of conflicts of interest that arise in agency theory ignores the following factors: discipline imposed on managers to fairly represent the interests of stockholders by potential mergers and acquisitions which often displace incumbent underperforming management; the latent powers and activism of institutional investors which often possess voting power to eject directors who support the management direction adopted; management incentives linked to stockholder returns are often sufficient to align the interests of management and stockholders; and the power of bondholders, bankers and other creditors of a corporation who impose management accountability through regular meetings with management. Where creditor influence can be exerted, imposition of financial covenants in debt agreements and a requirement by the corporation for a fixed return of interest and repayment of principal encourages a minimum level of financial performance to generate the necessary liquidity to service the debt. Weidenbaum and Jensen (1992) also argue that agency theory ignores the corporate responsibility as espoused by stakeholder theory explained below.

The approach adopted in this study doesn’t necessarily devalue the relevance of agency theory, rather, it focuses on other relevant qualitative factors which have impact inside and outside the firm. This is provided by examining events surrounding LB’s bankruptcy through the lens of New Institutional Theory and a Clegg’s (1989) Theory of Power.

Stewardship theory provides an alternative view and purports that the executive manager performs a custodianship for social standards (Davis et al. 1997; Donaldson & Davis 1991). “The manager far from being an opportunistic shirker essentially wants to do a good job, to be a good steward of the corporate assets” (Donaldson & Davis 1991, p. 51). Consistent with this approach is the notion that executive management should be represented on the Board of Directors. Executive management are perceived as possessing superior technical knowledge and operational expertise and therefore exercise decision-making responsibly

and support accountability (Muth & Donaldson 1998). Consequently stockholders could expect a superior organisational performance from their inclusion on the Board than that of a non-executive director, due to the associated knowledge asymmetry which exists between executive and non-executive directors. However Nicholson and Kiel (2007) suggest the adoption of a stewardship approach can result in governance failure, strategic drift or inertia. The kind of inertia of the board in addressing Fuld's flawed strategy and self-interest is evidence of a clear limitation of a potential application of this theory. The key limitation of using stewardship theory in this study is that it ignores the potential conflict of interest from the duality of role of chairman and CEO as existed in LB. This conflict of interest is revealed in detail in section 10.3.

Stakeholder theory, supported by Mitroff (1983) and Solomon (2007), can also explain corporate governance. It involves a social responsibility which includes social and environmental issues in addition to the maximisation of stockholder wealth as important factors in corporate governance. This theory accepts that stakeholders are both inside and outside the organisation. Examples of stakeholders include governments, the community, suppliers, customers and employees, all of whom can be impacted by organisational decision-making. Stakeholder theory argues that the organisation should be accountable to all such stakeholders (Freeman 1984). Ultimately, these stakeholders can affect the corporation. For example: customers could cease purchasing goods if they or their environment is treated adversely by the corporation; employees could strike and therefore cease production if their working conditions do not meet acceptable standards; a government which relies on taxation revenue could impose penalties due to the corporation's potential taxation evasion; and, suppliers' could cease delivery of essential goods if the corporation excessively delays creditor payments. This theory is criticised for promoting innocuous decision making which panders to a variety of stakeholders and therefore fails to exploit sensible risk taking and maximise firm value. There is also a lack of clarity as to the degree to which a board should take into account stakeholder interests, or at an extreme level, be accountable to stakeholders rather than be responsible to them. Application of this approach can result in unwieldy board structures which attempt to represent a variety of stakeholders, and thereby risk ignoring requisite board level skills necessary for effective decision making. As this theory focuses on the interests of stakeholders, it fails to adequately explain the complex power interactions between non-board member individuals within the organisation which impact on firm culture. It also largely ignores external influences on organisational culture as a background element to board decision making which is handled by New Institutional Theory. Resource dependency theory as espoused by Pfeffer and Salancik (1978) and supported by Nicholson and Kiel (2007) provides a framework which takes into account ambiguity caused by events outside the control of the organisation such as external environmental factors and reliance on external entities, and proposes that these factors can be minimised. This could be achieved by reference to professional advice, access to information, special

access to resources and legitimacy. In this context, the board is considered as a facilitator between the organisation and external entities. As survival and operational performance of organisations are dependent on other organisations, this theory proposes that the major role of the board is to attract the necessary resources through the management of external relationships. According to Pfeffer and Salancik (1978) board structure is therefore influenced by the ability of board members in engendering and influencing such relationships. The limitations of this theory is its mostly outwardly focused lens which diminishes the importance of internal power relationships. As shown in this chapter, the LB board was dominated by its CEO. The CEO's power over fellow board members and employees was instrumental in achieving an organisational strategy which facilitated his own personal objectives. Clegg's (1989) Theory of Power overcomes this limitation whilst New Institutional Theory is able to account for the external influences important in organisational culture and performance.

The use of both New Institutional Theory and Clegg's (1989) Theory of Power overcomes the various limitations mentioned above in addressing the corporate governance failure of LB. A key distinction between the abovementioned group of theories and the ones used in this thesis is that the former theories are premised on agency where the focus is on traditional accounting concepts of shareholder wealth. They relatively ignore the role of organisational culture and individual power relationships in effective corporate governance which is accommodated by the latter theories respectively.

Despite the various alternative theoretical frameworks mentioned above there is no conclusive evidence that one framework is more effective than the others in explaining corporate governance. Alina and Bogdan (2015, p. 682) asserts that "the best practices refer to those methods, techniques and instruments adopted by the company which ensures success and avoids failure in the future". Given that LB eventually failed, an examination of corporate governance practiced at LB is required to assess whether it did indeed reflect good practice or was impacted by either institutional forces and/or the exercise of power by the leadership of the organisation. Overriding all frameworks however, is the concept that professionalism encompasses consideration of all ethical matters. Was there a divergence between the appearance of corporate governance best practice and professional behaviour within LB?

Section 10.3 includes a critique of LB's Board and its committees, including their composition, size, specific knowledge, experience and frequency of meetings. These factors are considered important as they offer an indication of the effectiveness of a board's monitoring function (Abbott et al. 2004; Abbott et al. 2003; Carcello et al. 2002; Chen & Jian 2007; Krishnan & Jong Eun 2009). Zahra and Pearce (1989) emphasise the importance of the effective monitoring function of Boards in general. Zahra and Pearce (1989, p. 291) propose that there is a direct association between four board features such as characteristics, com-

position, structure and process and three critical board roles such as service, strategy and control. They find these links, specifically board size, board member attributes, the number and type of committees and elements of board meetings such as communication, agendas and documentation, affect the efficiency of the board monitoring role. This is particularly relevant to corporate performance. Walker (2004) also identifies the importance of board member attributes to corporate performance in the context of board committee membership. He noted that: "the performance of audit committees necessarily depends on the people involved, their knowledge, skills, critical capacities, scepticism and determination" (Walker 2004, p. 158).

Agency theory which Shleifer and Vishny (1997) applied in their assessment of corporate governance, claims that the only ethical action is the maximisation of shareholder wealth. This traditional approach offers a limited perspective to examine LB's attempts at practicing good corporate governance. This chapter extends Schleifer & Vishney's (1997) approach by explaining the practice of corporate governance as a social practice that reflects broader influences other than an agent / principal relationship. The analysis draws upon New Institutional Theory and Clegg's (1989) Theory of Power to explain firstly, the institutional influences that spurred LB to approach governance in a particular way and secondly, the power exerted by the CEO in shaping the governance structure to achieve his personal ambitions. The standards of corporate governance vary from country to country. However Shleifer and Vishny (1997, pp. 737-8) acknowledge that the corporate governance systems applied in the US, Germany, Japan and UK are amongst the best in the world. Although LB was based in the US where high standards for corporate governance were claimed to have existed, the GFC exposed certain failures of corporate governance systems as evidenced by the corporate failures referred to in CHAPTER 2.

The adoption of corporate governance principles by US corporations has been influenced by a regulatory approach. As mentioned above, there is a vast amount of literature that identifies the organisational factors necessary for good corporate governance. From a political perspective, the approaches could be separated into two groups along a regulatory versus neo-liberal spectrum. Some studies draw on the notion that market competition substitutes for a formal corporate governance system (Alchian 1950; Stigler 1958). An opposing view, suggests a prescriptive approach where legal systems which confer voting rights on stockholders are sufficient to protect stakeholders including minority interests (Easterbrook 1991; Hart 1995; Manne 1965). Protection is needed from mismanagement and manager self-dealing such as fraud, excessive compensation, or issues of equity to management. Consistent with this latter notion, the US has embraced a regulatory response to corporate governance to ensure at least a minimum level of governance is achieved. The implementation of these standards has largely entailed a combination of a statutory approach represented by the Sarbanes-Oxley Act of 2002 (SOX) and an industry supervisory approach represented by the NYSE corporate governance standards and guidance (New York Stock

Exchange 2012, 2014; Securities and Exchange Commission 2002). In addition to the abovementioned statutory and supervisory approach, US financial institutions have corporate governance responsibilities stemming from other government agencies listed in Figure 129.

Figure 129 - Corporate Governance Responsibilities for U.S. Financial Institutions

Organisation	Corporate Governance Document
Office of the Comptroller of the Currency (OCC)	OCC's Manual of Examination Procedures, in addition to the bank director guide.
Office of Thrift Supervision (OTS)	OTS's Thrift Activities Handbook and Thrift Holding Company Handbook.
Federal Deposit Insurance Corporation (FDIC)	FDIC's Division of Supervision Manual of Examination Policies.
Federal Financial Institution Examination Council (FFIEC)	Information handbooks on individual topics related to Information Technology.
Federal Reserve	Bank Holding Company Examination Manual.
	Trading and Capital Markets Activities Manual.
	Federal Reserve SR Letter 04-18, 'Bank Holding Company Rating System', December 6, 2004 (stating that the board's involvement will factor into the overall risk and composite ratings).
	Federal Reserve SR Letter 95-15, 'Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies', November 14, 1995.

Source: (Baret et al. 2009, p. 6).

The following sections outline the main US regulatory and supervisory guidance which applied to LB in constructing its corporate governance framework.

10.2.2 Sarbanes-Oxley Act of 2002 (SOX)

Following the collapse of major US corporations such as WorldCom and Enron, the US government acknowledged the failure of corporate governance in certain corporations and sought to introduce legislation to cover perceived gaps in governance practice. An analysis of corporate failures signal corporate governance issues which need to be addressed. This resulted in the enactment of the SOX (Securities and Exchange Commission 2002). This act represented a pivotal event in the development of good corporate governance in the US (Baulkaran 2014). The sections incorporated within the act are briefly outlined in the following table:

Figure 130 - Sarbanes-Oxley Act of 2002, Summary of Provisions

Section Heading	Description
Public Company Accounting Oversight Board (PCAOB)	The PCAOB provides independent supervision of public accounting firms which conduct audits. It is also responsible for registering auditors and outlines various requirements for audits.
Auditor Independence	This section deals with acceptable standards for external auditor independence, including the need for rotation of partners and reporting requirements.
Corporate Responsibility	Outlines the concept of individual responsibility by senior executives and their role in ensuring the publication of accurate and complete financial statements.
Enhanced Financial Disclosures	Specifically covers financial transactions, transactions of corporate officers, and timely reporting of material changes. It also covers a requirement for audits of internal controls and the ability for SEC reviews.
Analyst Conflicts of Interest	This section requires securities analysts to disclose conflicts of interest and lists their codes of conduct.
Commission Resources and Authority	The Commission Resources and Authority deals with the SEC's authority to bar or censure individuals including brokers, advisors, or dealers.
Studies and Reports	Requires the SEC and Comptroller General to conduct studies and reports covering the effects of consolidation of public accounting firms, the role of credit rating agencies in the operation of securities markets, securities violations, and enforcement actions.

Section Heading	Description
Corporate and Criminal Fraud Accountability	Outlines penalties for manipulation, destruction or alteration of financial records or perverting the course of official investigations. It also provides protection for whistle-blowers.
White Collar Crime Penalty Enhancement	Represented by the White Collar Crime Penalty Enhancement Act of 2002, this section highlights the penalties associated with white-collar crimes incorporating tougher sentencing guidelines.
Corporate Tax Returns	Requires the CEO to sign the corporate tax return.
Corporate Fraud Accountability	Represented by the Corporate Fraud Accountability Act of 2002, this section identifies corporate fraud and deems certain types of manipulation as a criminal offence which attract more severe penalties.

Source: A summary of Securities and Exchange Commission (2002).

Figure 130 offers a broad view of corporate governance from the perspective of the regulators. This chapter, however, focuses on the social practice of corporate governance, in particular that practiced by LB. As explained in the following sections, the LB approach to corporate governance entailed a tick-a-box approach to regulatory compliance instead of an overall system which encompasses a combination of values consistent with a social responsibility approach and actions reflecting fiduciary obligations.

10.2.3 NYSE Response to Corporate Governance

The US regulatory response is contained in The NYSE Listed Company Manual, and in SOX. In addition to the manual - New York Stock Exchange (2012), the NYSE has published a detailed NYSE Corporate Governance Guide for the creation of an effective corporate governance system (New York Stock Exchange 2014). The provisions contained in New York Stock Exchange (2012) as opposed to the NYSE Corporate Governance Guide, are mandatory (refer below for details).

New York Stock Exchange (2012) represents the NYSE's critical collection of policies, practices and procedures for US listed corporations (New York Stock Exchange 2012, p. 1). These regulations specifically cover various compliance requirements with matters relating to corporate governance contained in section 303A.09 (New York Stock Exchange 2012). In addition to requiring listed companies to adopt and disclose corporate governance guidelines, it provides a detailed listing of compliance provisions. An excerpt from New York Stock Exchange (2012) which outlines the mandatory subjects in a corporation's governance guidelines is set out below (Figure 131):

Figure 131 - NYSE Corporate Governance Standards

Subject	Description
Director qualification standards	These standards should, at minimum, reflect the independence requirements set forth in Sections 303A.01 and 303A.02. Companies may also address other substantive qualification requirements, including policies limiting the number of Boards, on which a director may sit, and director tenure, retirement and succession.
Director responsibilities	These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at Board meetings and advance review of meeting materials.
Director access to management and, as necessary, appropriate, independent advisors.	N/A
Director compensation.	Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The Board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary. Similar concerns may be raised when the listed company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The Board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director.
Director orientation and continuing education	N/A
Management succession	Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.
Annual performance evaluation of the Board	The Board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.

Source: A summary of New York Stock Exchange (2012 - section 303A.09).

The NYSE acknowledges the existence of various systems of corporate governance, and the potential confusion this may cause the corporate community (New York Stock Exchange 2014, p. 7). In response, it analysed a body of literature on the subject and incorporated its findings in the NYSE Corporate Governance Guide (Baulkaran 2014). Compliance with the

principles in the guide are not mandatory, however it simply provides a best practice framework for the voluntary adoption by US corporations. It outlines the NYSE view of aspirational best practices. The NYSE states that the aim of Boards should be to:

Oversee the successful, profitable, and sustainable operations of their companies. But the pressures that confront directors, from activism and short-termism, to ongoing shifts in governance, to global risks and competition, are many (New York Stock Exchange 2014, p. iii).

The New York Stock Exchange (2014) identified issues based on its review and noted that out of the 15 Board attributes analysed, 10 had either mixed results from the literature, or were determined to have no impact on the Board feature. A summary of the NYSE's review is presented in Figure 132.

Figure 132 - NYSE Summary of Corporate Governance Literature

Board Attribute	Explanation	Findings from NYSE Research
Independent chairperson	The chairman of the board meets NYSE standards for independence.	No evidence that this matters.
Lead independent director	The board has designated an independent director as the 'lead' person to represent the independent directors in conversation with management, stockholders, and other stakeholders.	Modest evidence that this improves performance.
Number of outside directors	Number of directors who come from outside the company (non-executive).	Mixed evidence that this can improve performance and reduce agency costs. Depends primarily on how difficult it is for outsiders to acquire expert knowledge of the company and its operations.
Number of independent directors	Number of directors who meet NYSE standards for independence.	No evidence that this matters beyond a simple majority.
Independence of committees	Board committees are entirely made up of directors who meet NYSE standards for	Positive impact on earnings quality for audit committee only. No evidence for other committees.

Board Attribute	Explanation	Findings from NYSE Research
Bankers	Directors with experience in commercial or investment banking.	Negative impact on company performance.
Financial experts	Directors with experience either as public accountant, auditor, principal financial officer, comptroller, or principle accounting officer.	Positive impact for accounting professionals only. No impact for other financial experts.
Politically connected directors	Directors with previous experience with the federal government or regulatory agency.	No evidence that this matters.
Employees	Employee or labour union representatives serve on the board.	Mixed evidence on performance.
'Busy' boards	A 'busy' director is one who serves on multiple outside boards (typically three or more). A busy board is one that has a majority of busy directors.	Negative impact on performance and monitoring.
Interlocked boards	An executive from Company A sits on the board of Company B, while an executive from Company B sits on the board of Company A.	Positive impact on performance, negative impact on monitoring.
Board size	The total number of directors on the board.	Positive impact on performance to have smaller board if company is 'simple,' larger board if company is 'complex'.
Diversity	The board has directors that are diverse in background, ethnicity, or gender.	Mixed evidence on performance and monitoring.
Classified (or staggered) boards	A board structure in which directors are elected to multiple-year terms, with only a subset standing for re-election each year.	Mixed evidence on performance and monitoring.
Director compensation	The mix of cash and stock with which directors are compensated.	Mixed evidence on performance and monitoring

Source: (New York Stock Exchange 2014).

Following its review, the NYSE noted a disparity in the literature relating to corporate governance whereby the traditional notions of best practice had been challenged. An assessment by van den Berghe (1999) of global codes of corporate governance revealed a lack of consistency amongst countries and inconclusive evidence of a 'single' best practice approach. In commenting on the available literature they concluded that "the research results, as well as opinions on the subject, are by no means unanimous" (van den Berghe 1999, p. 14). A more recent study by van Essen et al. (2013) supports van den Berghe (1999) and found that there is no universal prescription for good corporate governance and that "the efficacy of governance mechanisms may be contingent upon organisational and environmental circumstances" (van Essen et al. 2013) p.201. There is inconclusive evidence in the literature for any one approach to establish a checklist for effective corporate governance. The problem with much of the literature relates to several factors (Zahra & Pearce 1989). Firstly there is the tendency to universally relate board attributes and roles to corporate performance. Secondly, there is the relatively scant attention to the impact on board variables from contextual forces such as the size of the corporation or its life cycle. Thirdly, there is disagreement on what constitutes best practice for board processes and structure, and acceptable board objectives. Many variables play a part in determining "when boards exercise their power, how their actions may influence the direction the firm takes, and how directors bring about changes in the strategic initiatives advanced or implemented by senior executives" (Zahra & Pearce 1989, p. 325). Fourthly, there has been an over-reliance on univariate analytical approaches which ignore the antecedents and after effects of the variables chosen. This leads to the risk that the causal effects are not adequately identified and therefore any reliance on previous findings may extend the probability of diverse results. Fifthly, as the study of corporate governance covers a broad range of subsidiary topics, the range of samples used to conduct empirical analysis has been inadequate. Most studies relate to the US Fortune 500 corporations, whilst ignoring smaller and non-profit corporations. Sixthly, the definition of Board structure variables has been inconsistent. For example, the definition of an outside director still differs amongst researchers. Further, questions such as the differentiation between the roles of the CEO to that of the board and the extent of the board's expected strategic contribution to the corporation remain unresolved. Lastly, Zahra and Pearce (1989) identify the problem of a common tendency to measure corporate performance in a financial sense. Moreover common measures ignore other perspectives such as the social and systemic responsibilities of the corporation.

According to the New York Stock Exchange (2014, p. 8), there are certain contexts in which corporate governance may be considered favourable. Taking its review into account, the (New York Stock Exchange 2014) reached four broad recommendations in applying best practice corporate governance. Firstly, it recommends that Boards should adopt governance practices where there exists sufficient empirical evidence that those practices benefit the organisation. Given the significant amount of literature with different views on this subject,

incumbent Boards could be excused for being confused as to which practice to adopt. The New York Stock Exchange (2014) attempts to accommodate this difficulty by outlining board attributes that are supported by academic studies and their findings.

Secondly, the New York Stock Exchange (2014) advises that the context in which corporate governance systems are applied should be considered. It could be detrimental to an organisation applying a completely standardised governance system as a system's design should correlate to its setting. For example, a non-executive chairperson may be preferred upon the appointment of a new CEO, particularly when the appointee has no experience at CEO level and is internal. An independent chairperson can also benefit the organisation when a significant overhaul in strategy, culture or operations is required following a severe deterioration in performance. In this case major decisions such as a change in the leadership or a sale of the organisation can be undertaken without undue influence, and management distraction of strategic matters can be minimised.

However, on the other hand, according to (New York Stock Exchange 2014), a non-executive chairperson may be disadvantageous when an effective CEO/chairperson is already in place. The recruitment of a new CEO can be difficult when the incumbent holds both titles. Further, an independent chairperson could lead to inefficient strategic decisions especially when technical expertise is required and such knowledge is not easily transferrable from the CEO to the chairperson. Finally, separate CEOs and chairpersons can undermine leadership during a crisis (New York Stock Exchange 2014, p. 10). In addition to applying to the issue of appointing an independent chairperson, consideration of context is also valid for the majority of corporate governance policies (Millstein Center for Corporate Governance and Performance Yale School of Management 2009).

Thirdly, the New York Stock Exchange (2014) suggests that the functions of a governance system should take priority over its features. This avoids the superficial notion that the mere presence of a diverse, independent board with a standard set of board committees is sufficient for a corporate governance system to function. Similarly, the feature of a documented succession plan may be based on an assumption that it is a good one; and if the board has a risk committee, an assumption could be made that the organisation exercises careful risk management. Likewise it may be assumed that an optimal compensation structure for directors and management includes forms of equity as it provides appropriate incentives. As outlined in Figure 132, the research is not so definitive and boards should therefore avoid simply applying a standard governance system or feature and instead adopt a governance system that will indeed add value.

Lastly the New York Stock Exchange (2014) encourages directors to adopt an organisational perspective. This involves the acceptance that groups of individuals require adaptive and relevant monitoring. This oversight should take into account "personal and interpersonal dynamics, models of behaviour, leadership, cooperation, and decision-making" (New York

Stock Exchange 2014, p. 11). Specific areas to be considered include organisational design, organisational culture, CEO personality, and Board quality (New York Stock Exchange 2014). As discussed in section 10.3, these factors are particularly relevant in assessing LB's corporate governance framework.

In a case study covering four major US financial institutions (LB, Bear Stearns, Goldman Sachs, AIG), and one large US industrial corporation (General Motors) which encountered difficulties during the GFC, Aluchna (2013) compared the institutions' stated corporate governance and ethical pronouncements and documents to their actual practices. The study focused on the Board of Directors' role in overseeing the corporate governance implementation and monitoring functions. The deficiencies identified in Figure 133 were found to apply in varying degrees to all the subjects of the case study including the US investment banks (Aluchna 2013). The overarching problem was twofold.

Firstly the agency problem resulted from a short-term proclivity by senior executives for the maximisation of short term results at the expense of an overall responsibility to maximise stockholders' wealth over the long term – a core principle of agency theory. The Boards' monitoring role failed to identify this 'short-termism'.

Secondly, despite the existence of well documented corporate governance and ethical conduct policies amongst all case study subjects, the corporations failed to implement the core values contained in the policies into the corporations' everyday operations. The values espoused in the policy documents were largely ignored by senior executives and employees (Aluchna 2013, p. 128). Therefore the existence of the corporate governance and ethical conduct policies were seen to be more of an exercise in box ticking compliance than a meaningful implementation of the underlying objectives and values of such policies. A gap existed between the corporate governance system that corporations portrayed publicly and that which was practiced. The responsibility for establishing an effective corporate governance framework and an environment which sustains ethical behaviour is commonly regarded as the responsibility of the Board of Directors. The abovementioned gap may therefore be construed as a deficiency in the implementation of the Board's responsibilities. This deficiency could have arisen from a lack of understanding of the policies or as a consequence of undue pressure from other sources to disregard their importance:

The messages included in the code of ethics and the declaration of responsibility and integrity expressed by Bear Stearns, Lehman Brothers and Goldman Sachs proved to be empty declarations formulated solely for the purpose of formal compliance to satisfy shareholders and stakeholders expectations (Aluchna 2013, pp. 128-9).

Aluchna (2013, p. 128) conducted a study of three investment banks: Bear Stearns, Goldman Sachs and LB, and refers to four elements of corporate governance failures. In particular, these inadequacies include "inefficiencies of boards of directors; inappropriate executive

compensation structures; inadequate risk management procedures and policies; and intermediary inefficiencies.” An adaptation of Aluchna’s (2013) corporate governance deficiencies is set out in Figure 133.

Figure 133 - Main Corporate Governance Inadequacies of Failed Corporations in the GFC

Corporate Governance Area	Main Deficiency	Reference
Board of Directors	Insufficient management information system	(Gillespie & Zweig 2011)
	Overpowering CEO	
	Inefficient leadership team	
	Negative social perception	
	Questionable board composition	
	Lack of expertise on financial innovation such as derivatives	
	Inadequate financial skills	
Inappropriate Executive Compensation	Ineffectively structured to motivate executives to perform in the best interests of stockholders – ‘agency problem’	(Bebchuk & Fried 2005; Clarke & Chanlat 2009; Gillespie & Zweig 2011; Kennedy 2014; Rost & Osterloh 2009)
	Executives motivated by maximising financial outcomes.	
	Motivated high risk transactions resulting in short term payoffs	
	Increasing gap between CEO compensation and average employee. Gap extended from 280 times of average employee salary in 2004 to 520 times in 2008	
	Weak performance of Board Compensation Committees	
Risk Management	Inappropriate Board and management procedures. For example flawed value at risk systems	(Clarke & Chanlat 2009; Isaksson & Woodside 2016; Kennedy 2014)
	Use of poor quality information systems	
Relationship with Intermediaries	Flawed practices of CRA’s, securities analysts and investment managers	(Boerner 2008; Clapman 2007; Clarke & Chanlat 2009)
	Conflicts of interest and undue pressure from corporate relationships	

Source: Adapted from Aluchna (2013, p. 129).

There is no evidence of any regulatory breach by LB of the New York Governance Standards, however Aluchna (2013) identifies a number of weaknesses in LB’s corporate governance

practice. Of interest to this thesis is the impact that institutional forces and/or the undue influence of power in relationships had on the performance of LB. As stated by Alina and Bogdan (2015, p. 682) “the best practices refer to those methods, techniques and instruments adopted by the company which ensure success and avoid failure in the future”. This broad definition linking corporate governance to the future failure of a business is appropriate in the LB case study in view of the role played by LB’s Board in the lead up to its bankruptcy. In summary, an important function of an effective corporate governance system is an effective mechanism for the oversight and monitoring of management to avoid a future failure. This function is ordinarily carried out by a Board of Directors and therefore the structure of a Board is a vital component in the implementation of this objective. The following section analyses the influences which shaped the board structure of LB.

10.2.4 Board Structure

This section discusses the influences affecting LB’s Board structure. There is evidence to suggest that attributes of LB’s Board structure were influenced by normative pressure which is discussed below. Larcker and Tayan (2010) suggest that an ideal Board structure should start with a Board containing the following three characteristics. Firstly, a chairperson independent from management and preferably not concurrently acting as the CEO. This separation of dualities is commonly preferred as part of best practice corporate governance in view of the different responsibilities for each position. Another attribute includes a Board representation of sufficient size as to cover the requisite skills, knowledge and diversity of perspectives necessary to promote balanced and informed discussion. The diversity should cover professional expertise, ethnicity, age and gender. The Board should also comprise a number of independent directors who can serve the best interests of stockholders. Finally, Larcker and Tayan (2010) suggest that an ideal Board structure should include a compensation structure designed to avoid any agency problem. This is often achieved by including a significant portion of Board members’ compensation with corporate stock and/or options. An examination of these characteristics as they applied to LB is addressed in section 10.3. Despite its compliance with the New York Governance Standards and adoption of certain features of traditional corporate governance as suggested by Larcker and Tayan (2010), how did LB’s Board fail to mitigate the firm’s escalating financial difficulties and disregard a growing dysfunctional corporate culture? The following section analyses the normative and mimetic institutional influences exerted upon LB which led it to ignore the implementation of actual good governance practice.

10.2.5 Normative and Mimetic Influence over Board Structure

The adoption prior to the GFC of a similar board structure to that of Goldman Sachs, widely regarded as a successful US investment bank as was later found by its survival of the GFC in its original form (except for its eventual conversion to a bank holding corporation), could be viewed as the result of DiMaggio & Powell's (1983) normative and mimetic influence. This section shows that this influence impacted on the majority of US investment banks who were more concerned with regulatory compliance than practicing good corporate governance by instilling appropriate values in the day to day operations of the firms and at the top level of supervisory control – the Board of Directors.

Despite similarities in Board structure, the effectiveness of the corporate governance of two organisations may vary considerably (Larcker & Tayan 2010, p. 1). LB's Board structure was not vastly different from that of Goldman Sachs. In analysing LB's Board structure, on the surface, it complied with the New York Governance Standards (New York Stock Exchange 2012). For example, 10 of the 11 directors on LB's Board in 2007/2008 were classified as non-executive, reflecting an overwhelming number of non-executive directors; LB's Directors were a group whose backgrounds and experience were diverse; LB's Directors' compensation arrangements, which consisted of a mix of equity (restricted stock units and options) and cash, provided a level of performance incentive; and the Directors had a moderate workload imposed from membership of other boards which ensured sufficient focus could be devoted to the matters of LB – see Figure 134.

Even-though each of these attributes complied with the relevant regulations, a detailed discussion of the weaknesses for each attribute as they relate to LB is included in section 10.3. Figure 134 compares Board structural attributes of LB with those of Goldman Sachs. It is noteworthy that the board structures appear quite similar. A possible explanation for the similarity is explored below in this section.

Figure 134 - Board Structural Attribute Comparison between LB and Goldman Sachs as at 2005

Structural Attribute	Lehman Brothers	Goldman Sachs
Chairperson	Dual Chairperson/CEO	Dual Chairperson/CEO
Number of Board members	10 (increased to 11 by 2008)	11
Number of current CEOs/Chairmen/President of other corporations	3	4
Number of retired CEOs and years since their retirement	3 retired, average 12 years	2 retired, average 3.5 years
Independent Board members (according to NYSE)	8	9
Professional background of independent Board members	Former CEO Sotheby's	Former CEO Sara Lee
	Former Chairman IBM	Former Assistant to President of U.S.
	Theatrical Producer	Former CEO Medtronic
	CEO American Red Cross	CEO Allstate
	Chairman GlaxoSmithKline	President Brown University
	Vice Chairman RKO Pictures / Actress	CEO BP
	Former CEO Halliburton	Chairman Investor AB
	Principal JDM Financial	Vice Chairman Perseus
Average age of Board members	68.4 (increased to 68 years by 2008)	59.4
Number of men vs. women	Men: 8; Women: 2 (2008: 10 men and 1 woman)	Men: 9; Women: 2
Number of other Boards, trusteeships, committees and other appointments they currently serve on.	Boards: 19; Trusteeships: 12; Advisory Committees: 5; Other Affiliations: 10	Boards: 17; Trusteeships: 7; Advisory Committees: 4; Other Affiliations: 27
Average annual cash retainer (does not include committee fees)	USD 55,000	USD 75,000
Average annual equity compensation	USD 195,000 (either restricted stock units or options)	USD 260,000 (either restricted stock units or options)
Number of full Board meetings per year	8	7
Number of executive sessions (independent directors only) per year	3	5
Committee meetings per year	Audit: 7; Compensation and Benefits: 8; Nominating and Governance: 5; Finance & Risk: 2; Executive: 11	Audit: 11; Compensation: 5; Nominating and Governance: 5

Source: Data for the table was extracted from each corporations annual reports (Goldman Sachs Group 2005; Larcker & Tayan 2010, p. 3; Lehman Brothers Holdings 2005b).

As stated by Aluchna (2013), LB's Board structure mostly superficially resembled a model of good practice as defined by the regulatory environment. However from the perspective of efficient monitoring and control, it incorporated vital deficiencies in the context of LB's history and financial predicament just prior to its collapse. By ticking the regulatory boxes, LB's Board structure resembled that of Goldman Sachs. The fact that the board structures of both firms were similar may imply a mimetic pressure in an attempt to seek legitimacy amongst the banking, regulatory and investment communities. If LB mimicked the Board structure of Goldman Sachs, it sought to imitate an organisation which was deemed to be successful, thereby attracting legitimacy. It also generated a sense of security for investors, management and the board, supporting a proven tactic for survival. Appearing to adopt a similar board structure to its peer group, an investment bank avoids differentiation at this level of corporate structure from other investment banks. Any substantially different board feature may indicate non-compliance with socially accepted norms and potentially attract closer scrutiny by investors and regulators especially in cases of underperformance to a peer group. Closer scrutiny relative to the peer group runs the risk of detecting a lack of transparency, unexpected or extraordinary management practices or financial anomalies, which in turn could affect stakeholder confidence in the firm.

Additionally, similarity in Board structure also implies that both firms were intent on complying with regulations. If they breached regulations, then not only would they face the associated regulatory penalties, they would portray an image to the public and stakeholders, of a firm that did not have adequate management control. Such a perception could not only damage the firm's reputation, thereby impacting future business, but could infer to creditors, CRA's and other financial counterparties on whom the firm was reliant for ongoing funding, that the firm's credit risk profile had worsened.

A normative influence may have also affected LB and was potentially spurred by Riaz's (2009) concept of 'reverse legitimisation' referred to in section 3.1.3. The setting for 'reverse legitimisation' existed, as prior to the GFC all major investment banks were recording healthy profits. Their relative success created an environment whereby the regulatory authorities such as the NYSE and SEC, from which the investment banks sought legitimacy, were publicly endorsed for sustaining the development of and legitimising such successful organisations. This 'mutual legitimisation' perpetuated a perception that corporate governance practice was effective and proper in the investment banking industry. This perception was sustainable providing the corporate governance *modus operandi* of the investment banking peer group was consistent and did not deviate from established practices.

As Aluchna (2013) suggests, all major US investment banks complied with regulations. Therefore their Board features incorporated similar traits thereby creating the appearance that they were largely similar. As this thesis is attempting to explain, some of the underlying influences of LB's failure and a predilection to survive at all costs, an examination of board

structure and function deficiencies as opposed to Board features in general, would be more useful in examining whether an institutional influence existed. If so, the existence of a normative influence could not only help in understanding the failure of LB, but also the effective failure of all but one of the major US investment banks.

Aluchna (2013) identified four common corporate governance weaknesses (as outlined in Figure 133) in three major US investment banks, comprising the majority of the peer group. These common weaknesses as mentioned in the previous section included: “inefficiencies of boards of directors; inappropriate compensation structures; inadequate risk management procedures and policies; and intermediary inefficiencies” (Aluchna 2013, p. 128). Aluchna’s (2013) identified weaknesses are amongst those which New York Stock Exchange (2014) attempts to overcome. They also represent the weaknesses that Monks and Minow (2011) attempt to address. Monks & Minow’s (2011) synthesis of key board features is also consistent with those previously identified by (New York Stock Exchange 2014). These include: an efficient Board in which the CEO and Chairperson are different people; a sufficient number of non-executive directors to protect the interests of stockholders; Board committees such as nomination, audit and compensation committees with the necessary experience and expertise to cover decisions relating to the organisation; a compensation structure adequate to incentivise directors; and an active stockholder base willing to question the Board. In referring to Monks & Minow’s (2011) features, Aluchna (2013) concluded that these key features of good corporate governance attributes in general were inadequate for the three investment banks examined. In the analysis contained in section 10.3, all but the last of Monks & Minow’s (2011) features are critically analysed in the context of LB’s board structure. The feature involving an active stockholder base was not able to be critically evaluated given the lack of data.

‘Self-interest’ and ‘Short-termism’

The normative influence affecting the investment banking industry stems from two overriding factors. Firstly the inclination for self-interest in preference to a responsibility to stockholders, and secondly the tendency for a ‘short-termism’ approach to management decision-making. See section 10.5 for a discussion on employee compensation including self-interest as a driver in undertaking risky transactions as a means to increase employee incentive payments. Jensen (1994) argues that economic self-interest is driven by incentives which may cause irrational behaviour and is mostly favoured above altruism. Jensen further argues that individuals may have other motives. LB’s and in general, the industry’s choice to resort to high levels of monetary incentives created a tendency during the pre-GFC period to incorrectly discern the appropriate balance between financial incentives driven by self-interest and the opposing motive of prudential management of risk. This problem, identified by Jensen is blamed for system failures leading to large corporate collapses. “This phenomenon, for example, lies at the heart of the failure of the internal control systems that has led

to the waste of hundreds of billions of dollars of resources and the failure of many of the crown jewels of corporate America over the last several decades” (Jensen 1994, p. 8).

Secondly, there existed ambitions for each investment bank to practice ‘short-termism’. This phenomenon is related to the first factor, as ‘short-termism’ which drives the achievement of high short term profits, generally translates to higher executive and director short term compensation. Although these factors could relate to employees in an investment bank, the responsibility for the behaviours that led to this dysfunctional culture at LB must be at least partly ascribed to the Board of Directors which is ultimately responsible for the policies affecting compensation. As the normative pressure affected the organisation as a whole, the Board of Directors were not immune to its affects.

Each major US investment bank, like all US publicly listed corporations, was required to report its financial statements on a quarterly basis in accordance with the Form 10-Q reporting requirements of the SEC (*Securities and Exchange Act* 1934). The Form 10-Q quarterly report consists of unaudited financial statements intended to report on the continuing financial state of affairs of the corporation during its fiscal year. Stockholders, creditors and other stakeholders would be interested in following the progress of the corporation. Most importantly, creditors would be interested in the impact the financial statements would have on the corporation’s credit risk profile, and stockholders would be interested in the impact on returns. Financial results were therefore closely scrutinised by these stakeholders including investment managers and securities analysts whose comments were often quoted in the media.

The quarterly scrutiny of financial results generated pressure on each investment bank and in turn, their Board of Directors, to produce a higher result in each successive quarter to meet investor expectations. The inevitable comparison of each investment bank against its peer group’s performance by analysts compounded this pressure. Evidence of the focus on peer group comparison especially on key financial metrics by LB is found in the Lehman Brothers Global Strategy Offsite Presentation (Lehman Brothers Holdings 2006, pp. 5-7,14-5,30,4). This focus on peer group comparison represents 8 out of 38 pages of LB’s Corporate Strategy Presentation for 2006 (Lehman Brothers Holdings 2006). Goldman Sachs’ peer group comparisons focused on a combination of equity performance and divisional performance (Goldman Sachs Group 2006, pp. 13-4,5,7,9). Bear Stearns’ comparisons mostly related to divisional performance in terms of market rankings (Bear Stearns 2006, pp. 9-12,8,23,112); Morgan Stanley focused on peer group comparisons relating to divisional performance and staff quality (Morgan Stanley 2006); and Merrill Lynch focused on comparing its dominance in executing large transactions as well as its equity performance (Merrill Lynch 2008a, pp. 5-15,158). In each case, the investment banks were trying to establish a perception that they were performing satisfactorily and in line with or better than the peer group average in at least one performance metric.

In this competitive environment it was tempting to make management and strategic decisions to facilitate the objective of short term quarterly outperformance. In view of the industry peer group comparisons, a similarity of approach in dealing with decision-making of the business operations would not be unexpected. The consequence for being the lowest ranked investment bank in terms of performance could have resulted negatively on the firm's stock value relative to the peer group which would have disappointed stockholders. The normative influence driven by a common 'short-termism' approach sanctioned the internal decision-making of the firms. In the absence of any negative commentary from the public either in the media, directly from stakeholders, or through sanctions imposed by regulators, the investment banking firms appeared to comply with social norms. The commonality in approach by the peer group was spurred also by the circles, both informal and formal, in which the employees, senior executives and Directors mixed. For example it would not be unexpected for Directors of different firms to socialise at formal and informal events such as conferences or social clubs. The high level of contestability for employees mentioned in section 10.5 meant that employees rotated between employers as they shopped around for better compensation packages. The intermingling of employees between different firms, within professional forums and in educational settings resulted in the importation of employee values to the same firms (Galaskiewicz & Wasserman 1989; Slack & Hinings 1994). Ultimately these values would merge on an industry-wide basis and the same values would influence decision-making – leading to a common approach to 'short-termism' and tendency for self-interest. Other examples where the same normative influence fed into decision-making included the common pursuit of the 'leverage effect' which helped boost profitability at the expense of elevated risk levels; the growth in the use of credit derivatives which allowed the banks to expand risk exposures to relatively illiquid assets; and the practice of warehousing mortgages and CDOs, often through off-balance sheet structures, with the expectation of offloading these assets through securitisation. The latter practice generated a concentration of exposures to the real-estate market and in particular, the subprime mortgage market. Finally, Directors and employees would be attuned to the practices of other major investment banks given the media exposure associated with performance reporting and publicity surrounding major transactions, often involving merger and acquisitions and large scale corporate financings. A discussion of each corporate governance failure as identified by Aluchna (2013), including other factors considered as inadequacies in the LB case, is covered in section 10.3. The discussion includes DiMaggio & Powell's (1983) normative influence on Board structure and examines the use of Clegg's (1989) Theory of Power by the CEO in his relationships with Board members.

10.3 Relationship between the CEO and the Board

Fuld's interactions and relationship with the Board reflected Fuld's management style and created a power base from which he was able to influence Board members to implement strategic initiatives which were consistent with his own. This section covers the subtle organisational processes, structures and behaviours which enabled the CEO to influence the Board. Specifically, this section examines: the problem of duality of CEO and Chairperson roles and how this influenced the appointment process of board members; the risks posed to director independence by Board member longevity of tenure; Board composition, and questions relating to its suitability for a complex and innovative business; the level of director engagement in the decision-making process which devolved matters to a Board Committee whose priorities as a whole were misplaced; and finally the attractive level and structure of Board compensation, and its effect on Board compliance to the CEO's wishes.

According to New York Stock Exchange (2014, pp. 75-6) it is a common modern day governance practice to include independent directors on a Board to protect the interests of stockholders and other stakeholders. This practice is also included as a requirement of US corporate governance rules (New York Stock Exchange 2012 - 303A.01). In compliance with the NYSE requirement, LB's Board consisted of 10 independent directors out of a total of eleven directors. The only non-independent director was Fuld, who sat on the Board as Chairperson. Refer section 10.3.4 for a discussion of Board composition. A further factor considered as best practice by the NYSE Corporate Governance regulations, is to incorporate a range of Board committees to supervise certain operational aspects of an organisation's activities (New York Stock Exchange 2012 - 303A.04-303A.07). LB also complied with the NYSE Corporate Governance regulations having a number of such committees including: an executive committee; an audit committee; a compensation and benefits committee; a nominating and corporate governance committee; and a finance and risk committee (Lehman Brothers Holdings 2007, p. 2). In addition, LB was compliant with the New York Stock Exchange (2012 - 303A.03), as independent directors would regularly meet without the presence of executive management.

According to a testimony before the US House of Representatives Financial Services Committee investigating the role of LB in the GFC, Thomas Cruikshank, a longstanding Board member of LB since 1996, described the Board as a competent and involved body of advisors. "Board meetings were an active and dynamic affair. Board members probed management, asked numerous questions and demanded and received detailed, cogent answers" (Hearing before the Committee on Financial Services U.S. House of Representatives, Statement By Thomas H. Cruikshank 2010, p. 3). His testimony could be interpreted as one

which either attempted to deflect blame from the Board for LB's collapse, or a true belief that the Board performed acceptably in its overseeing role of the corporation. If the latter is to be believed, then given LB's collapse, Cruickshank's belief in a well-functioning board could be considered misplaced.

However, following an exhaustive examination of the fiduciary duties that Board members owed to the firm and their actions, Valukas (2010) found that 'colorable' claims⁸⁵ or actions did not exist with respect to their handling of the level of risk that LB had assumed and its liquidity issues (Valukas 2010, p. 52). This examination took into account whether the Board carried out its fiduciary duties according to the requirements of the regulatory framework existing at the time, which principally included compliance to SOX and the requirements under the New York Stock Exchange's regulations (New York Stock Exchange 2012). Refer sections 10.2.2 and 10.2.3 for an outline of the requirements of SOX and the NYSE respectively. For example, Title III of Securities and Exchange Commission (2002) obliges public corporations to apply standards for audit committee independence and responsibilities. Further the audit committee is required to commission the auditors, agree on the audit fees and oversee their activities with a final report to be reviewed by the Board. Audit committee members were required to be members of the Board of Directors and be independent. Finally, the audit committee had a responsibility to establish procedures for the processing of complaints related to financial reporting including those from employees who sought confidentiality. As long as the LB Board complied with its regulatory obligations, which it did according to a statement in Lehman Brothers Holdings (2007, p. 9), the bankruptcy examiner could not find 'colorable' claims against them.

Although the examination by Valukas (2010) exonerated the board, it found that 'colorable claims' existed against LB's executive management including: Fuld; O'Meara; Callan; and Lowitt, for decisions regarding the use of Repo 105 (discussed separately in CHAPTER 9) and for filing misleading financial statements that did not disclose such usage (Valukas 2010, pp. 990-1027).

Despite the findings of Valukas (2010) specifically relating to the board, questions remain regarding broader issues which were not examined by Valukas in detail, such as the ap-

⁸⁵ A 'colorable claim' is term used in the US legal system to describe a plausible legal claim which has a compelling chance of success subject to supporting available evidence.

pointment process for Board members, the Board composition, longevity of tenure and level of engagement of directors, their qualifications and relevant experience and whether their compensation structure was appropriate. These questions have even greater relevance given the increasingly sophisticated and complex business environment and innovative products involved in the investment banking industry. The Board's deficiencies and susceptibility to Fuld's influence is examined in the following section.

10.3.1 Duality of CEO/Chairperson Role is Subject to Normative Influence and Facilitates an Exercise of Power

As well as holding the position of CEO, Fuld was the Chairman of the Board - thereby contravening the first criterion of a well-functioning Board (Larcker & Tayan 2010). Aluchna (2013) is also critical of the duality of roles of CEO and Chairperson, explaining that this represents a major component of the 'inadequacies of the Boards of Directors'. The dual title not only afforded Fuld operational control of the firm through his role as CEO, but also a strong influence over the monitoring of management and strategic decision-making through his role as chairperson.

Fuld assumed the position of CEO and Chairman soon after incorporation in 1994, following LB's spin-off from American Express. As the Co-CEO of the Lehman Brothers division of American Express since 1990 up until its public listing, Fuld shared the top executive position in the LB organisation prior to the spin-off. As mentioned in section 5.2.1, Fuld ousted J. Tomilson Hill, the other Co-CEO in 1993 to assume the sole leadership position of the division. It was a natural succession for Fuld to the CEO role of the newly incorporated LB as he was the dominant leader of the LB division at that time.

Fuld was concurrently appointed Chairman presumably as the corporation had only just been listed and required a senior executive in the role with the experience and background necessary to steer the Board with its early strategic decision-making. At the time of his appointment as Chairman, LB was confronted with major challenges. As mentioned in section 5.2.1, immediately after the LB spin-off by American Express, LB was burdened with significant financial liabilities, a dysfunctional team where animosity existed between the investment banking and trading divisions and an economic downturn which affected revenues. In this environment, the appointment of an internal chairperson seemed reasonable. As detailed in section 10.2.3, and supported by the New York Stock Exchange (2014) and Vo (2010), there are limited circumstances when a combined CEO and chairperson may be beneficial. Most of the criteria set out by Vo (2010) in justifying a combined CEO and chairperson, applied to LB. These include: the incumbent CEO, Fuld, was already in place as the leader of the firm in a situation when there was no chairperson; Fuld possessed technical expertise and knowledge which would have been difficult to transfer to a new chairperson;

and finally the appointment of a separate chairperson could have destabilised the leadership of LB during the crisis that prevailed during the early 1990s.

The popularity of duality of CEO and chairperson has waned since the GFC as US corporations have attempted to implement the notion of good corporate governance by separating the two positions. Approximately seventy five percent of the Fortune 500 list of US corporations had a combined CEO and chairperson in 2004. This proportion has since reduced to approximately fifty percent in 2014 (Hodgson 2014).

However this justification for the dual role of CEO and chairperson can only be defended in the absence of duplicity between the operational management of the firm which is shared in the role of the CEO, and the effective monitoring role of the Board. That is, the situation should be avoided where the chairperson possesses abnormal power in the monitoring process of himself or herself in the role of CEO. If such power exists, then a conflict of interest arises and the suitability of a duality in the role is inappropriate. A discussion of the abnormal power of the CEO/Chairperson role is discussed in section 10.3.2. The duality of roles was tolerated by the investing public as it stemmed from a normative influence where such duality was seen as socially acceptable within the investment banking field and wider throughout the US corporate domain as mentioned above. Bear Stearns and Goldman Sachs were also led by individuals that held the dual title of CEO and Chairperson. The suggestion that the normative influence discussed in section 10.2.5 prevailed is supported by the same practice of other investment banks within LB's peer group which generated a social acceptance of this feature amongst stakeholders. Fuld continued in this dual role until LB's collapse suggesting that this acceptance by stakeholders continued whilst the firm performed strongly, thereby avoiding closer scrutiny of the firm's organisational structure.

Possessing the dual title of CEO and Chairman permitted Fuld to exert his influence not only over the management and employees of the firm, but also over the Board members. Therefore the board structure weakness of 'inefficiencies of boards of directors' identified by Aluchna (2013) was manifested in LB by the potential conflict of interest by the duality problem. The remaining section 10.3 discusses the influence Fuld exerted in his role as Chairman over the board through the lens of Clegg's (1989) framework of power.

10.3.2 Appointment of Board Members and Power through Social Relations

As demonstrated by Lehman Brothers Holdings (2008i, p. 6), LB's corporate governance practice relating to the appointment of Board members through an election process was in accordance with best practice as dictated by the New York Stock Exchange (2014, p. 72). Considerations for appointment of a Director included the following process:

In evaluating any potential candidate, the Nominating Committee considers the extent to which the candidate has the personal characteristics and core competencies discussed above, and takes into account all other factors it considers appropriate, which may include strength of character, mature judgment, career specialization, relevant technical skills, diversity and the extent to which a candidate would fill a present need on the Board of Directors. In addition, the Nominating Committee considers independence and potential conflicts issues with respect to Directors standing for re-election and other potential nominees, and whether any candidate has special interests that would impair his or her ability to effectively represent the interests of all stockholders. The Nominating Committee also takes into account the candidates' current occupations and the number of other boards on which they serve in determining whether they would have the ability to devote sufficient time to carry out their duties as Directors (Lehman Brothers Holdings 2008i, p. 12).

LB also complied with the (New York Stock Exchange 2012) requirement of an annual rotation:

All of the company's directors are elected annually for a one-year term expiring at the Annual Meeting of Stockholders in the following year. Each Director will hold office until his or her successor has been elected and qualified or until the Director's earlier resignation or removal (Lehman Brothers Holdings 2008i, p. 6).

Directors at LB were appointed through a process involving a Nominating and Corporate Governance Committee (the Nominating Committee) (Lehman Brothers Holdings 2008i). The responsibilities of the Nominating Committee were incorporated within LB's associated committee charter (Lehman Brothers Holdings 2008i, p. 11). Apart from covering the appointment of Directors, the Nominating Committee was also responsible for the corporation's general governance practices:

The Nominating Committee is responsible for overseeing the Company's corporate governance and recommending to the Board of Directors corporate governance principles applicable to the Company. The Nominating Committee also considers and makes recommendations to the Company's Board of Directors with respect to the size and composition of the Board of Directors and its Committees and with respect to potential candidates for membership on the Board of Directors (Lehman Brothers Holdings 2008i, p. 11).

The Nominating Committee was allowed to accept recommendations from the CEO for potential board candidates. This provided the CEO with some power in relation to the nomination process:

The Nominating Committee...will consider in a timely fashion potential candidates for director that have been recommended by the Company's Directors, Chief Executive Officer and other members of senior management (Lehman Brothers Holdings 2008i, pp. 11-2).

For example, in 2004, Sir Christopher Gent was initially recommended to the Nominating Committee by Fuld and a senior executive. The nomination was supported by the executive

search firm, Spencer Stuart. It was usual practice for LB to employ executive search consultants to assist with the search of Board member candidates. For example, in 2007 LB employed Ridgeway Partners LLC, in 2005 Russell Reynolds Associates, and in 2004 Spencer Stuart (Lehman Brothers Holdings 2004, p. 9; 2005b, p. 10; 2007, p. 6). Ideally the search firm would be independent and without any conflicts of interest. However Ridgeway Partners was routinely used by LB as a consultant (Bloomberg 2008). The relationship between Fuld (and his senior executives involved in general recruitment) and Ridgeway Partners LLC suggests that the independence of this executive search firm may have been compromised. As it would be in the interests of the executive search firm to accommodate the needs of its client [LB] in its business relationship, a potential motivation existed for Ridgeway Partners LLC to be strongly guided by Fuld in the selection of a Board candidate. This layer of influence over Board nominations was augmented by the power of the CEO and senior management to conduct interviews of potential director candidates. Baulkaran (2014, p. 459) shows that:

firms with individual director election and detailed disclosure of voting results in director elections have a higher firm value or performance. Firms with independent chairman, majority voting, and detailed disclosure of voting results in director elections have lower idiosyncratic risk.

There is insufficient evidence of this level of transparency regarding director elections at LB. However, Fuld possessed potential influence over the Board to recommend Board candidates for nomination and to be involved in the interview process, the authority being in the Nomination and Corporate Governance Committee charter since 1994 (Lehman Brothers Holdings 1995, p. 7).

As evidenced by Lehman Brothers Holdings (1995, p. 7), Fuld was a member of the Nominating Committee from the beginning. The fact that Fuld was a member of the Nominating Committee at time of incorporation allowed him to influence Board nominations from the start of the conversion process from a division of American Express to a publicly listed corporation. At that time the Nominating Committee could be considered the most important committee as it was responsible for appointing new Board members during the early life of LB and therefore influence the long term agenda of the firm. More importantly the newly formed Board and committees would set the tone for their ongoing approach to monitoring management. Fuld filled this committee with members whom he considered would approach their role with a strategic view of the firm in a manner consistent with his own.

The Chairman of the four member Nominating Committee at the time of incorporation in 1994 was John MacComber, who remained on the committee until LB's bankruptcy. Therefore from the four members on the Committee in 1994, one was the CEO and one was a long serving Director who largely owed his Board appointment to Fuld. MacComber, who was also a member of the two man Executive Committee, alongside Fuld, could therefore be

considered an ally and able to influence the Nominating Committee in a way that suited Fuld for the remaining duration of LB's independent corporate existence.

Fuld's power to nominate Directors is understood within the context of Clegg's (1989) dispositional and episodic circuits. The process of appointing a Board member involved the nomination process which started with recommendations from either Board members, executive search consultants or the CEO/senior management to the Nominating Committee which would then make its recommendation to the Board. Following a vote approving the recommendation, the Board would propose the candidate to stockholders at the annual general meeting, where following approval, the director was formally appointed. The key steps in the process included the support for the candidate at the Nominating Committee and later from the majority of the incumbent Board. Stockholder meetings habitually approved the Board's recommendation. As Chairman, Fuld had an influence in both key decision forums of the Nominating Committee and the Board over which he presided. The nomination and interview process represent a passage point which relayed Fuld's authority to exercise his right to nominate and interview directors and therefore impose his preference for a particular type of director. Without this ability, Fuld would have been disempowered.

The Committee charter defined formalised or fixed relations between the Board and the Nominating Committee. The Board merely ratified Board nominations presented by the Nominating Committee. The charter granted Fuld the authority to recommend and interview candidates and therefore was the source of the latent power which emanated from the dispositional circuit where the relations between Committee members and Fuld were established. The Committee members, who were subject to Fuld's influence, exercised their power over Board appointments in the episodic circuit, during their routine deliberation of candidates. In their meetings, Committee members would discuss potential candidates whose suitability would be assessed. The forum of the Committee meetings therefore represented the passage point where Fuld's power to influence the Committee was exercised. In turn the Committee forwarded their recommendation to the Board who would normally ratify the candidate for election by stockholders.

The ability granted to Fuld to recommend potential directors would have been tolerated given the Board presided over a successful period of superior financial results up until the year prior to its bankruptcy. This reflected well on Fuld and his team, who had operational control during the period. The crediting by the board of the successful performance to its CEO is also recognised by the compensation arrangements under which Fuld was employed. The arrangements stipulated the major objectives of the CEO role, and methods to evaluate Fuld's management capabilities against key performance indicators (Lehman Brothers Holdings 2008i, pp. 24-7). A consequence of the firm's ongoing success was the creation of a perception to the outside of a well-functioning Board. LB's continuing success validated the

Board's decision-making to internal and external stakeholders. A well-functioning Board therefore implied a well-considered director nomination process.

10.3.3 Board Tenure – A Facilitator of Power

An argument exists that a long term Director on a board can offer greater experience, commitment and competence in view of the intimacy they develop of the corporation's operations and interest in its continuing survival, either due to loyalty or long term compensation arrangements. However studies have found the opposite phenomenon. Katz (1982) finds that long term tenure diminishes internal communication effectiveness and engenders complacency amongst Directors in seeking out key information sources. Katz (1982) also finds that although a new Director's learnings of a corporation increases in the early years of their tenure, which can positively affect firm performance at that time, performance deteriorates thereafter. Stobaugh (1996) suggests that to enable new ideas and critical thinking which encourage positive performance, the maximum term of a Director's tenure should be approximately 10 years, a term which is shorter than the average tenure of 11 years for LB's Directors (Lehman Brothers Holdings 2008i, pp. 48-52). Lipton and Lorsch (1992, p. 66) also support the notion of a limit to a Director's tenure to avoid relationship issues with the CEO.

Vafeas (2003) finds that as director tenure lengthens, the potential for a sociable relationship with management increases, which in turn impacts on director independence. He also suggests that longer serving directors are more likely to support management decisions, and as they become friendlier are less likely to monitor senior management. (Vafeas 2003) further suggests this is more likely to occur in firms with more powerful CEOs, especially those who have a role in board member nominations. "Independent directors or not, if you've been on the board for a while, there is a possibility that some of the directors do get closer to management" (Goodlad 2014). The tenure of individual members of LB's Board and the Nominating Committee varied, however it was considered lengthy given that Board rotation was annual. LB's longevity of board tenure of 11 years was not unusual for major US investment banks. For example, the average tenure of directors at Goldman Sachs was 8 years (Goldman Sachs Group 2007b, pp. 8-10); and for Bear Stearns it was 13 years (Bear Stearns 2007b, pp. 3-2).

The tenure of the Nominating Committee as a group was also lengthy. In 2008 this Committee consisted of the Committee Chairperson, Ms. Evans, and two other independent Directors, Cruikshank and MacComber (Lehman Brothers Holdings 2008i, p. 11). Ms Evans, the exception, had been a Board member for four years, Cruikshank 12 years and MacComber 14 years. With an average of 15 years, it was longer than the Board average of 11 years. Refer to Figure 135 for the tenure of all Board members. Another influential committee, the Executive Committee, had two members in 2007/2008: Fuld and MacComber. MacComber was the longest serving independent director on the Board, having been appointed at the

time of incorporation in 1994 (Lehman Brothers Holdings 2008i). Having MacComber on the Executive Committee, Fuld potentially captured the Director with the greatest degree of loyalty given his longevity of tenure. Further he was a member of the Nominating Committee which conferred influence over director appointments. The Executive Committee met frequently, more than any other Board committee. It convened 16 meetings during fiscal 2007 and at each meeting during that year unanimously approved all resolutions (refer Figure 137 for the number of meetings held by each committee). The fact that each Executive Committee meeting acted with unanimous consent every time it met implied that MacComber was in full agreement with Fuld on every decision undertaken by the Committee. The Executive Committee possessed significant power given it could exercise the Board's authority on all matters between Board meetings, except for those matters that required specific Board approval.

Therefore given MacComber was the longest serving Board member, his potential to succumb to Vafeas' (2003) notion of 'director friendliness' was greater than all other Board members. Occupying key positions on the Executive and Nominating Committees, MacComber was the conduit for Fuld's influence over important committee level decisions. Given the longevity of tenure of the Board as a whole, all Directors had the opportunity to create personal relationships with senior management and employees. These personal relationships could have been nurtured through various interactions between management and the board. For example, during Board presentations, corporate functions, Board dinners, external conferences, offsite strategy meetings, seminars and intimate meetings for technical instruction on specific operational matters relating to the business. This potential familiarity could have extended to a point where Directors could have acquiesced to requests by senior management for action on routine or strategic decisions.

The Chairman's dominant role on the Board, and his social relations with board members, created potential power over incumbent Board members. Fuld could have been perceived by Board members as the individual largely responsible for their appointment. This perception would create a sense of obligation by a Board member, to support Fuld's future Board member nomination recommendations. This circuit of behaviour which entailed the creation of a sense of obligation perpetuated Fuld's power over the Board.

The relations between Directors and Fuld and expectations of compliance with Fuld's wishes represent socially constructed rules created within the dispositional circuit. That is, once the sense of obligation spurs repetitive compliance, the behaviour is transformed into a socially constructed rule which is routinely adhered to by directors. Fuld's power created from this routine behaviour was facilitated by his role in the nomination process which is deemed the passage point where power is transmitted. Any action to recommend a Board candidate for nomination is an exertion of Clegg's (1989) power facilitated through the passage point of the nomination process and passing through to the episodic circuit where nominations are

formalised in the normal course of business. In the ongoing stewardship of LB the extent to which Fuld was able to influence specific decisions depended on the complicity of Board members.

Under US common law, Directors have a fiduciary duty of care on behalf of stockholders (*Burt v. Irvine Co* 1965) and loyalty to the corporation (*Cede & Co. v. Technicolor* 1993). These duties are intended to discourage any conflicts of interest of the Director which may affect the corporation. As the corporation is owned by stockholders, then any conflict of interest is deemed as one against the stockholders as well as the corporation. However, as mentioned above, to the extent Directors have more direct and frequent personal contact with senior executives than with stockholders, they may tend to develop better social and interpersonal relations with the former. Director contact with stockholders on the other hand would be often conducted on an impersonal basis and through indirect channels such as through corporate executives, investment or public relations firms and departments, and printed documents. A potential conflict therefore arises when a Director establishes a more intimate relationship with management, who themselves are the subject of the Board's monitoring, than with the stockholders. As mentioned above the influence over nomination of Directors could also be exerted via external search consultants who may be beholden to management for future business. The same consultants could also be engaged to provide recommendations for the firing of Directors. Consequently, the tenure of Directors, through these intermediary business and social relationships, could have been determined by the CEO.

Employees at LB feared to challenge the CEO (refer section 10.4 which includes a detailed discussion on the influence exerted by the CEO on employees). Within this culture where employees and Board members were relatively powerless against the dominant wishes of the CEO, the authoritative role of the Board is transmitted to the CEO – the opposite of what is considered good corporate governance practice. “Interaction between board directors and corporate executives that is markedly supportive and accommodating may signal the board's improper deference to, and mere rubber-stamping of, executive decisions and conduct” (Vo 2010, p. 82). Therefore the first of Aluchna's (2013) board structure weaknesses is found to exist in LB given the potential for a conflict of interest between the Directors acting in the best interests of stockholders and their acquiescence to the CEOs personal objectives.

10.3.4 Board Composition – Appropriate for a leading Investment Bank?

An analysis of the Directors' backgrounds (refer Figure 135 for details of directors' backgrounds during 2008) reveals that most directors did not have direct senior executive or

board backgrounds in either banking or financial services. This is despite LB's statement that the Nominating Committee should consider board candidates who will:

contribute knowledge, expertise or skills in at least one of the following core competencies: a record of making good business decisions; an understanding of management best practices; relevant industry-specific or other specialized knowledge; business experience in international markets; a history of motivating high-performing talent; and the skills and experience to provide strategic and management oversight, and to help maximize the long-term value of the Firm for its stockholders (Lehman Brothers Holdings 2008i, p. 11).

As confirmed by Lehman Brothers Holdings (2008i, p. 11) An important competency for a board member of an investment bank includes relevant 'industry-specific' or other 'specialised' knowledge. As investment banks operate in a fast moving environment where product innovation is a key feature, specific knowledge of products and credit exposures and their associated risks is considered fundamental. For those directors who had some related experience, Berman (2008) suggests it was not recent. Until Jerry Grundhofer a former US Bancorp CEO, was appointed no other independent director with recent experience specifically covering banking and financial market activities and products existed on LB's board until 2008 (Lehman Brothers Holdings 2008i). Although some Board members possessed some finance industry experience, Berman (2008) suggests it was well outdated, given the rate of innovation occurring during the 1990s and 2000s. The currency of knowledge required to stay abreast of innovations and related risks of financial products such as securitisations, credit-default swaps, or derivatives trading was beyond the mostly retired members of the Board.

The question then arises as to whether directors were actually selected for their lack of experience in complex investment banking activities, so as to facilitate Fuld's control. Examples of Board appointments of unqualified directors include that of Roger Berlind (director at the time of collapse) who was a theatrical producer; Dina Merrill (director until 2006), a career actress who was 85 years old upon retirement and Marsha Evans, a former head of the Red Cross and retired navy admiral (Berman 2008). Although this composition of Directors meets the diversity criteria of good governance, the inexperience in financial markets and products is considered an overriding quality necessary for an investment bank which operates in a complex environment. There is no evidence that any of these directors had backgrounds with such expertise.

Another feature of the Board was their age. The average age of LB's Directors was 68 years as at 2008 (see ages of all directors in Figure 135). This exceeded the average of 61 years for directors of large US corporations as at 2008 (Spencer Stuart 2012, p. 17). According to Alzheimer's Disease Research Centre (2017), certain cognitive abilities deteriorate at varying rates, as individuals age, in particular after 60. The cognitive abilities which experience deterioration and considered important for Directors include:

fluid intelligence or abilities not based on experience or education; recent memory or the formation of new memories; paying attention to electronic devices; word retrieval or the process of getting words out; problems that have not been encountered during your life; and the speed with which cognitive and motor processes are performed (Alzheimer's Disease Research Centre 2017).

Further, five of the 10 independent directors in 2008 were aged over 70 and 6 directors had been retired from their previous executive roles, several of whom for an average period of over 12 years (Berman 2008). Importantly LB's Board did not include any members who were concurrently in a CEO role elsewhere (Lehman Brothers Holdings 2008i, pp. 6-8). A final question over the composition of the Board was the gender imbalance which favoured males by a ratio of 10 to 1. Refer Figure 135 for a list of Board members including a brief description of their experience at the time of the LB bankruptcy.

Figure 135 - LB Board of Directors – as at 2008

Name	Director Since	Experience	Age
Richard Fuld	1990*	He was President and Co-Chief Executive Officer of the Lehman Brothers Division of Shearson Lehman Brothers Inc. from August 1990 to March 1993. Fuld was a Vice Chairman of Shearson Lehman Brothers from August 1984 until 1990 and has been a Director of LBI since 1984. Fuld joined Lehman Brothers in 1969. Fuld serves on the Board of Directors of the Federal Reserve Bank of New York and is a member of the Executive Committee of the Board of Directors of The Partnership for New York City. He is a member of the International Business Council of the World Economic Forum and The Business Council. In addition, he serves on the Board of Trustees of Middlebury College and New York Presbyterian Hospital, as well as on the Board of Directors of the Robin Hood Foundation.	62
Michael L. Ainslie	1996	Michael Ainslie, a private investor, is the former President, Chief Executive Officer and a Director of Sotheby's Holdings. He was Chief Executive Officer of Sotheby's from 1984 to 1994. From 1980 to 1984, he was President and Chief Executive Officer of the National Trust for Historic Preservation. From 1975 to 1980, he was Chief Operating Officer of NRen Corp.,	64

Name	Director Since	Experience	Age
		a Cincinnati-based chemical manufacturer. From 1971 to 1975, he was President of Palmas Del Mar, a real estate development company. He began his career as an associate with McKinsey & Company. Michael Ainsle is a Director of The St. Joe Company and Lehman Brothers Bank, FSB. He is a Trustee of Vanderbilt University and a member (and the Chairman Emeritus) of the Board of Directors of The Posse Foundation, Inc.	
John F. Akers	1996	Akers, a private investor, is the retired Chairman of the Board of Directors of International Business Machines Corporation. Akers served as Chairman of the Board of Directors and Chief Executive Officer of IBM from 1985 until his retirement in 1993, completing a 33-year career with IBM. Akers is a Director of W. R. Grace & Co. He is a former member of the Board of Trustees of the California Institute of Technology and The Metropolitan Museum of Art, as well as the former Chairman of the Board of Governors of United Way of America. Akers was also a member of former President George Bush's Education Policy Advisory Committee.	74
Roger S. Berlind	1985	Berlind, who is also a private investor, has been a theatrical producer and principal of Berlind Productions since 1981. Berlind is also a Governor of the Broadway League and has served as a Trustee of Princeton University, the Eugene O'Neill Theater Center, the MacDowell Colony and the American Academy of Dramatic Arts.	77
Thomas H. Cruikshank	1996	Cruikshank was the Chairman and Chief Executive Officer of Halliburton Company, a major petroleum industry service company, from 1989 to 1995, was President and Chief Executive Officer of Halliburton from 1983 to 1989, and served as a Director of Halliburton from 1977 to 1996. He joined Halliburton in 1969, and served in various senior accounting and finance positions before being named Chief Executive Officer. Cruikshank is a Director of LBI.	76

Name	Director Since	Experience	Age
Marsha Johnson Evans	2004	<p>Ms. Evans served as President and Chief Executive Officer of the American Red Cross from August 2002 to December 2005. She previously served as National Executive Director of Girl Scouts of the USA from January 1998 until July 2002. Ms. Evans was a career officer in the United States Navy, retiring as a Rear Admiral in January 1998. She served as superintendent of the Naval Postgraduate School in Monterey, California from 1995 to 1998 and headed the Navy's worldwide recruiting organization from 1993 to 1995. She is a director of Weight Watchers International, Inc., Huntsman Corporation and Office Depot, Inc. She also serves on the Advisory Boards for the Ladies Professional Golf Association and the Pew Partnership for Civic Change, a project of the Pew Charitable Trusts, and is a director of the Naval Academy Foundation and America's Development Foundation.</p>	60
Sir Christopher Gent	2003	<p>Sir Christopher Gent has been Non-Executive Chairman of GlaxoSmithKline plc since January 2005. He was Non-Executive Deputy Chairman of GlaxoSmithKline plc from June 2004 to January 2005. Prior to his retirement in July 2003, he had been a member of the Board of Directors of Vodafone Group Plc since August 1985 and its Chief Executive Officer since January 1997. Sir Christopher joined Vodafone as Managing Director of Vodafone Limited in January 1985 when the mobile phone service was first launched, and held that position until December 1996. Prior to joining Vodafone, Sir Christopher was Director of Network Services for ICL. In this role, he was Managing Director of Baric, a computer services company owned jointly by Barclays and ICL, and was responsible for ICL's computer bureau services worldwide. Sir Christopher was Knighted for his services to the mobile telecommunications industry in 2001. He is a Director of Ferrari SpA, a Senior Advisor to Bain & Company, Inc. and a member of the Advisory Board of Reform. He served as the National Chairman of the Young</p>	59

Name	Director Since	Experience	Age
		Conservatives from 1977 to 1979, and was Vice President of the Computer Services Association Council at the time he left ICL.	
Jerry A. Grundhofer	2008	Grundhofer is the Chairman Emeritus and retired Chief Executive Officer of U.S. Bancorp. Grundhofer served as the Chairman of U.S. Bancorp from December 2002 until December 2007. Grundhofer also served as President and Chief Executive Officer of U.S. Bancorp from February 2001 until October 2004 and December 2006, respectively. From 1993 until February 2001, he served as Chairman, President and Chief Executive Officer of U.S. Bancorp predecessors Firststar Corporation and Star Banc Corporation. Grundhofer is a director of Ecolab, Inc. and The Midland Company, Inc.	63
Roland A. Hernandez	2005	Hernandez is the retired Chairman and Chief Executive Officer of Telemundo Group, Inc., a Spanish-language television station company, where he served from August 1998 to December 2000. From March 1995 to August 1998, he served as President and Chief Executive Officer of Telemundo Group, Inc. Prior to that position, Hernandez was founder and President of Interspan Communications, a company engaged in a variety of services related to Spanish-language media. Hernandez is also a Director of MGM Mirage, The Ryland Group, Inc., Vail Resorts, Inc. and Wal-Mart Stores, Inc. In addition, Hernandez serves on advisory boards for Harvard University's David Rockefeller Center for Latin American Studies and Harvard Law School, as well as the board of Yale University's President's Council on International Activities.	50
Henry Kaufman	1995	Dr. Kaufman has been President of Henry Kaufman & Company, Inc., an investment management and economic and financial consulting firm, since 1988. For the previous 26 years, he was with Salomon Brothers Inc., where he was a Managing Director, Member of the Executive Committee, and in charge of Salomon's four research departments. He was also a Vice Chairman of the parent company,	80

Name	Director Since	Experience	Age
		Salomon Inc. Before joining Salomon Brothers, Dr. Kaufman was in commercial banking and served as an economist at the Federal Reserve Bank of New York. He is a Member (and the Chairman Emeritus) of the Board of Trustees of the Institute of International Education, a Member of the Board of Trustees of New York University, a Member (and the Chairman Emeritus) of the Board of Overseers of the Stern School of Business of New York University and a Member of the Board of Trustees of the Animal Medical Center. Dr. Kaufman is a Member of the International Advisory Committee of the Federal Reserve Bank of New York, a Member of the Advisory Committee to the Investment Committee of the International Monetary Fund Staff Retirement Plan, a Member of the Board of Governors of Tel-Aviv University and Treasurer (and former Trustee) of The Economic Club of New York.	
John D. Macomber	1994	Macomber has been a Principal of JDM Investment Group, a private investment firm, since 1992. He was Chairman and President of the Export-Import Bank of the United States from 1989 to 1992, Chairman and Chief Executive Officer of Celanese Corporation from 1973 to 1986 and a Senior Partner at McKinsey & Company from 1954 to 1973. Macomber is a Director of Collexis Holdings, Inc., Stem Cell Innovations, Inc. and Stewart & Stevenson LLC. He is Chairman of the Council for Excellence in Government and Vice Chairman of the Atlantic Council. He is a Trustee of the Carnegie Institution of Washington and the Folger Library.	80

* Director prior to public listing on NYSE.

Source: (Lehman Brothers Holdings 2008i, pp. 48-52).

10.3.5 Director Engagement

In addition to the lack of appropriate qualifications of the board as a whole and the above average age compared to directors of other large corporations, is the issue relating to the level of engagement of directors in monitoring the activities of LB's management. As a quali-

tative question, it is difficult to assess. Media reports suggest that Fuld was “aggressive, confrontational and blunt” (Serwer 2006, p. 1). These characteristics suggest dealings with the CEO would have been problematic. Such a character would have required a strong willed Board willing to question him. However Serwer (2006, p. 2) suggests that “there is evidence the Board was not particularly structured to provide either oversight of management or strategic advice. Instead, the responsibilities of independent directorships appeared to be perfunctory”.

As mentioned in section 10.3.4, as a whole the Board should possess core competencies which include relevant industry-specific or other specialised knowledge. If this concept is extended to the membership of a Board committee, then it would be expected that a Board committee should consist of at least one member that is expert in the area for which the committee is responsible. The membership of the various Board committees is set out in Figure 136.

Figure 136 - LB’s Board Committees

Committee	Members	Committee Function
Executive Committee	Chairman - Richard Fuld John D. Macomber	Has the authority, in the intervals between meetings of the Board of Directors, to exercise all the authority of the Board of Directors, except for those matters that the Delaware General Corporation Law or the Company's Restated Certificate of Incorporation reserves to the full Board of Directors. The Executive Committee acted by unanimous written consent 16 times during the fiscal year ended November 30, 2007 (Fiscal 2007)

Committee	Members	Committee Function
<p>Audit Committee</p> <p>(Must be independent under NYSE corporate governance and SEC rules)</p>	<p>Chairman - Thomas H. Cruikshank</p> <p>Sir Christopher Gent</p> <p>Michael Ainslie</p> <p>Roger S. Berlind</p>	<p>The Audit Committee assists the Board of Directors in fulfilling its oversight of the quality and integrity of LB's financial statements and its compliance with legal and regulatory requirements. The Audit Committee is responsible for retaining (subject to stockholder ratification) and, as necessary, terminating, the independent registered public accounting firm. The Audit Committee annually reviews the qualifications, performance and independence of the independent registered public accounting firm and the audit plan, fees and audit results, and pre-approves audit and non-audit services to be performed by the independent registered public accounting firm and related fees. The Audit Committee also oversees the performance of the LB's corporate audit and compliance functions. The Audit Committee held 11 meetings during Fiscal 2007.</p>

Committee	Members	Committee Function
<p>Compensation and Benefits Committee</p> <p>(Must be independent under NYSE corporate governance, SEC and the Internal Revenue Code rules)</p>	<p>Chairman - John F. Akers</p> <p>Sir Christopher Gent</p> <p>Marsha J. Evans</p> <p>John D. Macomber</p>	<p>The Compensation Committee has general oversight responsibility with respect to compensation and benefits programs and compensation of the LB's executives, including reviewing and approving compensation policies and practices, such as salary, cash incentive, restricted stock unit awards (RSUs), long-term incentive compensation and other programs, and grants under such plans. The Compensation Committee evaluates the performance of the CEO and other members of senior management and, based on such evaluation, reviews and approves the annual salary, bonus, share and option awards, other long-term incentives and other benefits to be paid to the CEO and such other members of senior management. The Compensation Committee also reviews and discusses the Compensation Discussion and Analysis with management and, if appropriate, recommends to the full Board of Directors that it be included in the LB's filings with the SEC. As a part of its review and establishment of the performance criteria and compensation of senior management, the Compensation Committee generally meets separately at least annually with the CEO, LB's principal human resources executive and any other corporate officers as the Compensation Committee deems appropriate. The CEO and the COO provide annual performance reviews and compensation recommendations to the Compensation Committee for each of the other executive officers, and the CEO does so for the COO in the latter's absence. The Compensation Committee held seven meetings and acted by unanimous written consent twice during Fiscal 2007.</p>

Committee	Members	Committee Function
Nominating and Corporate Governance Committee (Must be independent under NYSE corporate governance rules)	Chairperson – Marsha J. Evans Thomas H. Cruikshank John D. Macomber	Is responsible for overseeing LB's corporate governance and recommending to the Board of Directors corporate governance principles applicable to LB. The Nominating Committee also considers and makes recommendations to the LB's Board of Directors with respect to the size and composition of the Board of Directors and its Committees and with respect to potential candidates for membership on the Board of Directors.
Finance and Risk Committee	Chairman - Henry Kaufman Roland A. Hernandez John F. Akers Roger S. Berlind Marsha J. Evans	The Finance Committee reviews and advises the Board of Directors on the financial policies and practices of LB, including risk management. The Finance Committee also periodically reviews, among other things, budget, capital and funding plans and recommends a dividend policy and Common Stock repurchase plan to the Board of Directors. The Finance Committee held two meetings during Fiscal 2007.

Source: (Lehman Brothers Holdings 2008i, pp. 9-11).

Two of the most important committees in the period preceding the collapse included the Audit and the Finance and Risk committees as they were responsible for the firm's financial position and risk profile. These committees were viewed as important in the oversight of the firm's accounting, finance and risk functions and therefore relevant to LB's eventual bankruptcy. Accordingly members would be expected to possess some experience in at least one of these fields of expertise which had also undergone a significant period of innovation. In view of the rapidly evolving nature of the investment banking industry a current knowledge of the products and activities would be required to fully understand the corresponding risks and impacts on the financial position of the firm.

The Finance and Risk committee consisted of its Chairman, Henry Kaufman, president of Henry Kaufman & Company, Inc., an investment management and economic and financial consulting firm; John Akers, retired Chairman of International Business Machines Corporation; Roland Hernandez, retired Chairman CEO of Telemundo Group, Inc; and Roger Berlind, and Marsh Evans whose relative inexperience was described above. One of the five committee members, Dr. Kaufman, possessed relevant financial markets industry experience (Lehman Brothers Holdings 2007). Members of both the audit and finance and risk committees were personally endorsed by Fuld (McDonald & Robinson 2009). Inadequate risk man-

agement practices were prevalent at LB (Valukas 2010 Vol 8, Tabs 8-22). A Finance and Risk committee lacking the necessary expertise and understanding of the complex risks faced by a modern investment bank could easily lead to a systemic risk management failure as experienced by LB. Fuld had a stated objective of growing the firm aggressively, and generating increasing profits on a quarterly basis. Any restrictions on this objective posed by the Finance and Risk Committee would have represented an obstacle to Fuld. Major transactional and balance sheet risks would be routinely assessed by the Finance and Risk Committee, often accompanied by management recommendations. As CEO, Fuld would have supported management recommendations on the proviso they were consistent with his objectives. Therefore it was in Fuld's interest to have the Finance and Risk Committee approve the risks he supported. Given the shortage of expertise on the Finance and Risk Committee, the knowledge asymmetry, whereby management's expertise exceeded that of the overseeing Committee, represented fertile territory for Fuld to exercise his influence in the Committee's decision-making process.

The possession of superior knowledge and expertise over the Finance and Risk Committee enabled management to exercise power generated in Clegg's (1989) facilitative circuit. For the power to exist, the knowledge asymmetry needed to represent technology or innovation necessary in the business operations of the firm. In this scenario, management recommendations relating to risk could be pushed through the Committee, whose potential to challenge the technical aspects under consideration were limited. The Finance and Risk Committee meetings represented the passage point for decisions to be implemented by management as evidenced by the minutes of the committee meetings. The approved recommendation would pass through the passage point to the episodic circuit where the action of implementing the recommendation would be carried out in the normal course of business. The authority to act in the episodic circuit was officially granted to the relevant employees – the agents - by the instrument of the committee minute which was generated under the influence of management. As a result management were able to achieve the risk and credit exposures and balance sheet leverage it desired to maximise profits.

LB's Board of Directors conducted eight meetings during the fiscal year 2007. "Each Director attended 75% or more of the aggregate of (a) the total number of meetings of the Board of Directors held and (b) the total number of meetings held by all Committees of the Board of Directors on which he or she served. Overall Director attendance as a group at Board and Board Committee meetings during Fiscal 2007 was 96%" (Lehman Brothers Holdings 2008i, p. 18). Although these statistics appear acceptable when measured in aggregate, the focus of the Board's attention and relative pro-activeness of a committee can be gauged by the frequency each committee met. Figure 137 sets out the number of meetings for each board committee in the latest fiscal year prior to LB's collapse:

Figure 137- Number of Committee Meetings

Board Committee	Financial Year ended 30 November 2007
Executive Committee	16
Audit Committee	11
Compensation and Benefits Committee	7
Nominating and Corporate Governance Committee	Not available
Finance and Risk Committee	2

Source: (Lehman Brothers Holdings 2008i, pp. 9-11).

During the 2007 fiscal year, a period when risks were escalating, and the financial markets were experiencing increased volatility, the finance and risk committee met only twice. LB's compensation committee instead convened seven meetings (Lehman Brothers Holdings 2008i, pp. 9-11). The frequency of committee meetings could have reflected the relative importance to LB of the area covered by each respective committee. Based on this assumption, compensation arrangements were more important to LB than risk matters. As McDonald and Robinson (2009, p. 226) states: "King Richard had even turned Lehman's Board of Directors into a kind of largely irrelevant chamber. This was yet another group to rubber stamp his decisions and collect generous fees".

Referring to the failed financial institutions during the GFC, Gross (2010, p. 1) claims that "These companies had Board members who either weren't paying attention or, at Lehman in particular, were deliberately selected because they were unqualified or out of it". Gillespie and Zweig (2011) also finds that directors were obliged to CEOs for their positions and were disengaged from the operations of the firms they were supposed to monitor.

10.3.6 Board Compensation

LB Board members were well compensated. Refer Figure 138 for a table of LB's Board members' compensation for the full year prior to LB's bankruptcy.

Figure 138 - LB Board Compensation in 2007

Non- Executive Directors ¹	Fees USD	Stock Awards USD	All Other Com- pensation USD	Total USD
M. L. Ainslie	95,000	245,038	² 57,500	397,538
J. F. Akers	115,500	245,038	0	360,538
R. S. Berlind	107,500	245,038	0	352,538
T. H. Cruikshank	140,000	245,038	0	385,038
M. J. Evans	128,000	245,038	0	373,038
C. Gent	120,500	245,038	0	365,538
R. A. Hernandez	80,000	245,038	0	325,038

Non- Executive Directors ¹	Fees USD	Stock Awards USD	All Other Compensation USD	Total USD
H. Kaufman	95,000	254,388	0	349,388
J. D. Macomber	132,000	245,038	0	377,038
Average				365,077

- 1) Grundhofer is absent from the above list as he was appointed in the 2008.
- 2) In relation to serving as a Director, Chairman of the Audit Committee and member of the Compensation and Benefits Committee in Fiscal 2007 for other LB associated corporations, Lehman Brothers Bank and FSB, Ainsle received additional cash compensation.

Source: (Lehman Brothers Holdings 2008h).

The above director compensation levels appear attractive when compared to the average non-executive director compensation for US corporations in 2006/2007. Figure 139 outlines the median of the non-executive director's compensation for the Fortune 500⁸⁶ list of US corporations in the 2006/2007 fiscal year. Compensation levels listed in Figure 139 include fees for participation in audit and compensation committees, which are two of the more common Board committees in the US. The average amount paid to LB directors of USD 365,077 represents more than double the national average of USD 181,250.

Figure 139 - 2006/2007 Average Compensation Non-Executive Directors of US Corporations

Fortune 500 Non-Executive Board Director CompensationMedian for 2006/2007	
	USD
Directors Fees*	165,000
Audit Committee	10,000
Compensation Committee	6,250
Total	181,250

Note* Directors' fees are defined as the sum of annual retainers and Board meeting fees, excluding any committee fees.

Source: (Compensation Force 2017).

⁸⁶ The Fortune 500 is a list of the 500 largest US corporations ranked by total revenue. The list which is based on publicly available financial data is published annually by Fortune magazine.

Further, LB Directors' compensation levels for 2007 ranked as the second highest of the peer group. This ranking is not considered extraordinary as LB was ranked second highest based on return on equity for 2007 (refer section 7.3 for detailed analysis of LB's relative financial performance). However comparing compensation levels to returns ignores the other major factor in firm survivability (a responsibility of directors), which is the firm's level of risk. Figure 140 compares the US investment bank peer group's average compensation levels for directors to each firm's leverage which is considered a simple and appropriate measure of risk for this exercise. Any statistical analysis of the variables affecting compensation is complex and is outside the scope of this thesis. Therefore the data in Figure 140 and related commentary is presented as observations of factors which may be considered as important in motivating director behaviour. Return on equity which is a measure of firm performance is also included in Figure 140 for comparison purposes. A firm which values prudent stewardship would reward effective risk management practice and attempt to adjust its director compensation level to account for a measure of risk.

Goldman Sachs stands out amongst the peer group as its director compensation level is significantly higher than all other investment banks. This is expected given its higher performance as measured by ROE. Moreover, Goldman Sachs was able to outperform its peers whilst maintaining the lowest leverage. This means that it is paying its directors a significantly higher multiple per unit of risk (as measured by leverage) indicating a rewarding of effective risk management.

However this association is not clear for the other banks. A minimum level of director compensation would be required to attract board candidates regardless of the risk level of a firm. This implies there is a 'fixed component' to compensation regardless of risk and return. LB had the second highest leverage of the peer group (behind Merrill Lynch) and yet paid the second highest director compensation (behind Goldman Sachs). Excluding Goldman Sachs, the firms' leverage ratios are grouped within a narrow range of 32 to 37 times, whereas the ROE ratios vary considerably from -42.9% to 26.7%. Figure 140 shows the association between board compensation and return is strong, whilst the same cannot be said for the association between compensation and risk.

Figure 140 - Director Compensation Compared to Firm Leverage

Investment Bank	Average Compensation per Director	*Leverage Ratio	Return on Equity
	USD'000	Times	%
Goldman Sachs	641	24	35.2
LB	365	36	26.7
Morgan Stanley	343	32	8.9
Merrill Lynch	265	37	-42.9
Bear Stearns	226	35	5.5

Investment Bank	Average Compensation per Director	*Leverage Ratio	Return on Equity
Peer Group Average	368	32.8	6.7

*Note: Leverage = Total Liabilities / (Total Equity - Intangible Assets).

Source: (Bear Stearns 2007b; Goldman Sachs Group 2008b; Lehman Brothers Holdings 2008h; Merrill Lynch 2008b; Morgan Stanley 2008b).

The relatively high level of compensation earned by LB directors indicates two issues which supports Aluchna's (2013) concept of board structure weakness of 'inappropriate compensation structure'. Firstly, as mentioned above, the compensation structure seemingly ignores risk. Secondly, the compensation levels, representing a level well above the national average of US corporations, and the second highest level for the peer group, creates an incentive for LB's Directors to remain on the LB Board. This is borne by the relatively high longevity of tenure of the Board. An additional enticement not to resign from the board included a compensation structure which included options exercisable over the long term:

The options have a ten-year term, are not forfeitable, and become exercisable in one-third instalments on each of the first three anniversaries of the grant date or sooner upon termination of service (Lehman Brothers Holdings 2008i, p. 14).

The above average level of compensation earned by LB's non-executive directors empowered the CEO by encouraging directors not to defect to LB's competitors.

10.3.7 Summary of Fuld's Power over the Board

Fuld was the linchpin between executive management and the Board and pursuant to section 10.3.2 appeared to have orchestrated the composition of the Board. The combined factors of: a CEO also possessing the title of Chairman; a Board whose members occupied their roles for a considerable number of years sufficient to build a familiarity with management; ageing directors mostly retired from their previous executive roles lacking in the currency of modern investment banking innovations; a major lack of relevant expertise and experience of most board committee members necessary to make informed decisions in their area of responsibility; attractive board compensation arrangements which enticed board members to remain on the board and perpetuate their longstanding friendly relationships with the Chairman; and a committee meeting schedule favouring compensation over finance and risk matters led to a less than optimal monitoring role and level of engagement from the Board.

In analysing this orchestration it can be seen that Fuld was able to exert his influence through all three of Clegg's (1989) circuits of power. In the episodic circuit, Fuld established social relations with the Board as a group and individually with its members. These relations

were established informally through Fuld's intermittent interaction with each member on a day to day basis. The Board became Fuld's agency in generating the outcomes he wanted. His influence over the Board's frequent decision-making was realised through his orchestration of a Board with limited capacities and means. Any of the abovementioned limitations could have contributed to the performance of the Board. It could have included the lack of skill and expertise of members, or their ageing profile which potentially affected their cognitive abilities. In either case, Fuld harnessed this power to achieve his desired outcomes.

By arranging the directors' contractual appointments and related generous compensation packages which encouraged a degree of acquiescence, he fixed relations with the board. This fixing of relations is a condition for the generation of power in Clegg's (1989) dispositional circuit. Moreover Fuld's social relationship with the Board was formalised through his capacity as a formal leader of the group represented by his title of Chairman. Whether formalised, conveyed through various presentations or informally during Board meetings, the Board were made aware of Fuld's strategy of growth (Lehman Brothers Holdings 2006). This type of communication reinforced Fuld's intentions for the firm, implying that any challenge to his strategy would be met with resistance. See section 10.6 for a discussion on the rhetoric used in LB's strategy documentation.

Through interactions in the facilitative circuit where power is generated with knowledge and skill which is described by Clegg (1989) as a 'technology of production', the Board was found to be deficient. As section 10.3.4 argues, it lacked the necessary experience, skill and knowledge to be abreast of the latest technologies of production, that is, the financial innovations occurring during the previous decade. A knowledge asymmetry existed between senior management who routinely operated in this complex environment and kept up to date with developments, and certain board members, many of whom had no recent experience in the financial markets and some of whom were retired.

As this section illustrates, it is not only the structural elements of corporate governance that are important, but the qualitative aspects of a Board such as skill currency, director engagement, effective independence and its resistance to strong personalities within management. The following section explores how the relationship between the CEO and the firm's employees would shape the firm's culture into one which reflected the CEO's own set of values and beliefs.

10.4 Relationship between the CEO and Employees

As mentioned in section 10.3, Fuld's overriding strategy was 'growth'. This strategy presumed that profitability would follow growth and with an increase in profitability would come an improvement in bonuses and firm reputation. Fuld's interactions with employees, viewed as a reflection of his management style, defined the firm's culture. This section analyses certain interactions and events which characterise his management style and its impact on the firm's culture which contributed to the decisions that led to its downfall. To understand the source of Fuld's management style, it is important to explore the influences on his early career.

10.4.1 Influences on Fuld's Early Career

As mentioned in section 5.2.1, Fuld was the protégé of Lew Glucksman, the CEO of LB between 1983 and 1984 and former head of the Trading Division where Fuld was employed for most of his junior career. Fuld possessed a similar management style to that of Glucksman whom he revered. Auletta (1985, p. 16) describes Glucksman as a "jungle fighter" and according to an observation of a fellow Board member at the time: "Glucksman's flaw was that there was an angry pig inside the man. He wasn't after money. He was after power, complete control" (Auletta 1985, p. 16). As Fuld had worked under Glucksman almost his entire career, it is not surprising that some of Glucksman's traits and prejudices were assimilated.

Glucksman's ascent to power occurred whilst presiding over the Trading Division, which as mentioned in section 5.1.10 generated the majority of the firm's profits in the early 1980s. Fuld shared this experience where generating ever increasing profits ensured the retention of power. An autocratic and dismissive management style which Fuld brought to his interactions with internal advisors could have stemmed from his observations of Glucksman. His suspicion of internal power struggles and fear of being usurped in a similar manner as Glucksman and Petersen beforehand, prompted Fuld to value his hold over the leadership of the firm.

10.4.2 Fuld's Treatment of Employees – Abuse of Power

Fuld's treatment of employees was generally driven by his motivation to generate growth for the firm and any employee who offered obstacles or resistance to this objective would suffer his scorn or worse still, dismissal. To gain an understanding of how Fuld's treatment of employees reflected his management style, a series of examples are presented below.

Madelyn Antoncic, 55 years old in 2007, and a PhD from The Stern School of New York University, was an experienced risk professional who prior to joining LB had worked for several well-known institutions. These included: The Federal Reserve Bank of New York as an economist; Goldman Sachs where for twelve years she worked as a mortgage backed structured products trader and later headed the department of market risk management; and Barclays Capital New York Branch where, as the Treasurer for the Americas, she established the market risk function and later became a member of the executive committee and the board of directors. She was also a senior figure in the Girl Scout Movement of New York. In 2005, Antoncic was voted the 'Risk Manager of the Year' by Risk, an international risk journal, and she was also named among the US top one hundred most influential people in finance. Antoncic joined LB in 1999 and from 2002-2007, she served as Chief Risk Officer (CRO) reporting directly to Fuld. (Mathiason et al. 2009; McDonald & Robinson 2009).

It was common practice at most banks including LB to eject the originating deal team from the risk discussion relating to any major transaction elevated to the executive committee for approval. This practice was common amongst banks and investment banks in view of the inherent bias to influence an approval of a transaction by the deal team as more deals translated to higher potential bonuses. By late 2006, Antoncic was also ejected when risk issues were being discussed during executive committee meetings. This highly unusual move, initiated by Fuld, coincided with her cautionary advice and recommendations of a reduction in risk exposures made to the executive committee based on her view that the markets, especially the property market had become overheated (Onaran 2008). In September 2007, following her advice of caution to the executive committee, Antoncic was demoted from her role as CRO, to occupy the position of Global Head of Financial Policy Relations where she remained until LB's bankruptcy. Valukas (2010, p. 46) in his report found that:

Emails written by LB risk management personnel suggest that Lehman senior management disregarded its risk managers, its risk policies, and its risk limits. Press reports prior to Lehman's bankruptcy stated that in 2007 Lehman had removed Madelyn Antoncic, Lehman's Chief Risk Officer (CRO), and Michael Gelband, head of its Fixed Income Division (FID), because of their opposition to management's growing accumulation of risky and illiquid investments.

Two months after her transfer, at a risk management conference in New York, Antoncic declared that it was difficult for top management to accept the hedging of LB's mortgage positions as the hedges would curtail the firm's profit (Mathiason et al. 2009; Onaran 2008). In an interview in 2016, Antoncic revealed a glimpse of LB's risk culture describing it as one that didn't prioritise the risk management function and that transactions involving credit risk were facilitated with a relatively easy approval process:

The fabric was torn away little by little. We were encouraged to take more and more risk and it was not making a lot of sense. The biggest risk is complacency. By the beginning of 2007, I

was stepped aside because I was considered old fashioned...It's about culture...It sends a signal message to the rest of the teams and minimises authority of people in risk management. The head of the commitment committee wanted to approve anything that came in at the front door...This doesn't make a lot of sense. Everybody was working in silos, building up risks that were additive (Antoncic 2016).

Antoncic also expressed the difficulties in communicating with Fuld regarding risk matters, emphasising the need for a strong, confident character to overcome Fuld's resistance to prudent risk considerations. Antoncic implied that LB's risk culture should have emanated from the Board and risk committee level, however she herself questioned whether LB's Board fully appreciated the appropriate risk tolerances for an investment bank:

It was so important to have someone with a not shy, strong personality and confidence to be a risk manager to speak up...possess the right set of morals. A risk culture depends on having the right board and appropriate risk committee and needs to be strong to be able to challenge the chairman (Antoncic 2016).

Antoncic's comments confirm the findings in section 10.3 of a weak risk committee, which together with the board did not possess the requisite expertise in risk matters, were unable to establish an appropriate risk culture and were allowed to be influenced by Fuld's strong character. As mentioned in section 5.2.8, Michael Gelband who headed the Fixed Income Division was also induced to leave in May 2007 following his resistance to taking additional risk (Valukas 2010, p. 149). Gelband warned Fuld of an imminent market correction in the property market in line with Antoncic's advice and the CRAs' warnings, and during a meeting with Fuld was told "You're too conservative... You don't want to take risk " (McDonald & Robinson 2009, p. 235).

Joe Gregory, COO held the same optimistic view on risk and growth as Fuld. He understood that to perpetuate growth in profitability, an increased level of risk was desirable. Gregory suited Fuld's management style given that Gregory posed no threat to Fuld's leadership and would carry out Fuld's bidding unflinchingly (McDonald & Robinson 2009). In a similar warning as given by Gelband, Alex Kirk, the Global Head of Convertible Trading, cautioned Gregory of the unacceptable risk that LB was incurring. In a discussion about risk, and in taking his lead from Fuld, Gregory responded by telling Kirk, "You can stay if you want, but there's no place for you" (McDonald & Robinson 2009, p. 279). Soon after this conversation in February 2008, Kirk resigned (RTT News 2008).

10.4.3 Power through the Dispositional and Episodic Circuit

The above examples highlight Fuld's use of power within two of Clegg's (1989) circuits of power. The CEO or through his deputy, could hire, promote, transfer or dismiss subordinates, in accordance with the authority granted by the organisation's established hierarchical reporting lines. The formal reporting lines represented obligatory passage points be-

tween the dispositional circuit and the episodic circuit. Fuld's power was transmitted from the dispositional circuit where the power to hire or dismiss is established by formal rules contained in employment agreements. These agreements establish the hierarchy within the organisation. As CEO, Fuld was at the top of the management hierarchy and in this position held the ultimate power to dismiss an employee.

However as senior advisors to Fuld and the executive committee, Antoncic, Gelband and Kirk possessed authority sourced from their technical knowledge, expertise and relative seniority within the firm. This authority by each of the experts was formalised through their job design contained in their employment contracts. Both job design and technical knowledge are common traits which enable the generation of power in the facilitative circuit. They were therefore empowered to influence decision-making in the firm. As the experts projected a severe deterioration in the property market from 2007 onwards (McDonald & Robinson 2009), the external environment in which LB operated, posed a significant challenge to the continuing strong financial performance of LB. In fact the experts predicted significant financial losses given LB's over-exposure to mortgage backed derivatives. Against this expected change in external economic conditions, the experts' power is reinforced within the facilitative circuit, where such power can be constituted through environmental contingencies. The facilitative circuit becomes a means of allowing variation in the circuits of power (Clegg 1989, p. 233). The expected change in economic conditions enriched the experts' power as their advice in such adverse conditions made it even more valuable. The transmission of this enhanced power through the passage point of the executive committee meetings was usurped by Fuld's disregard of their advice. Through the resolutions of the executive committee, Fuld could activate his decisions within the episodic circuit where such decisions would be carried out by operational staff under the passage points of routine instructions in the day to day activities of the firm.

The nullification of the experts' authority by Fuld exercising formal power obtained under the firm's hierarchical structure carried unintended consequences. Fuld could have exercised a consultative style of management by acceding to the learned advice and be a leader who respects others' opinions and applies measured and well informed judgement. These leadership traits are often valued in an environment where innovation and initiative are important, such as is the case in the investment banking industry. However by admonishing the experts, through the exercise of formal power, Fuld ran the risk of creating a culture of fear, and worse still a culture potentially invisible to his organisational surveillance. Fuld's capacity to be remote from employees had already been recognised by staff who thought that "he was in some kind of ivory tower" (McDonald & Robinson 2009, p. 97). If advice from the various experts differed, then the CEO could be easily justified in pursuing the particular route which offered the path of least divergence to his own biased views. However all three experts offered the same views on the risks posed by the mortgage and property markets in the US at the time. The challenge to an intellectual authority posed by a uniform

and consistently strong view of the risks to the firm only heightened the danger to Fuld of adversely impacting the culture of the firm. Ultimately, in their challenges to Fuld's views of the firm's risk taking, Antoncic, Gelband and Kirk, experienced retribution in the form of either a transfer from their current position, reprimand or a persuasion to exit the firm.

As mentioned above, the act of dismissing a subordinate from a position is viewed as an exercise of power transmitted from the dispositional circuit through to the episodic circuit. Clegg (1989) notes that power can be transmitted in the episodic circuit as individuals attempt to address interpersonal conflicts. In the examples above, when Fuld or his deputy Gregory were confronted with opposing views to their own on the topic of risk, they exercised power simply by the act of removing dissenters from their positions. Gregory's (COO) own dismissal is another example of Fuld's exercise of power as a means of pursuing his own ambition to survive the leadership of the firm. Gregory was Fuld's trusted lieutenant of 30 years and not immune to Fuld's ire in this circumstance. On 12 June 2008, Gregory was dismissed from LB following the announcement of a loss of approximately USD 2.8 billion for the second quarter of the 2008 fiscal year. McDade, a younger man known for his cautious approach to risk-taking was installed as the replacement COO (Plumb & Wilchins 2008b). This act was carried out at a time when Fuld was fighting for survival and needed to convey a perception to the market he was addressing the firm's risk profile. The severity of the decision to dismiss such a long-standing ally and the second most senior executive in the firm signalled a desperate attempt by Fuld to retain control. Ironically, it was engineered to appear as a sacrifice of a senior executive who was responsible for the excessive risk taking of the firm yet the same attitudes to risk were shared by Fuld. The fact that Fuld remained as CEO attempted to signal to the market his relative lack of culpability for the firm's financial difficulties.

The period following the announcement of such a large loss marked a point in time when the market's confidence in Fuld was in decline as reflected in LB's stock price (refer Figure 83 showing the decline in stock price during 2008). The decline in the fortunes of investors, the escalating risk to creditors and the increasing probability that staff would be compelled to forsake bonuses, led to a reduction in Fuld's apparent power. To neutralise the appearance of a loss of power, Fuld had decided to seek a scapegoat in the form of Gregory. Fuld's hope was that decisive action would quell an unsettled group of investors and creditors and increasingly disgruntled employees. The incongruity of the decision to dismiss Gregory was that both Gregory and Fuld had concurred on the same agenda of pursuing growth based on an elevated risk profile for the firm. However Fuld appeared to take none of the responsibility. This inequitable imposition of responsibility for the loss was made possible by Fuld's power not only through his position in the hierarchy – a power as discussed above, generated in the dispositional circuit - but through the dramatic change in the firm's circumstances. The loss in the second quarter of fiscal 2008 was the first loss recorded by LB in many years and therefore represented a significant change not only in the perceptions of the firm from

an external viewpoint but also from an internal perspective. In order to retain the confidence of external investors and creditors as well as employees, Fuld needed to draw on his formal power to act. Given the severe change in the financial markets which contributed to the loss, Fuld was able to generate some power constituted through the change in environment, which as mentioned above is found in the facilitative circuit. Again the impact of this power is seen in its transmission to the episodic circuit where the act of dismissal was seen as a necessary operational outcome of the functioning of the business. The problem however arises that once the change in environmental condition is well known and accepted as an existing condition, how would Fuld continue to generate sufficient power to overcome any further loss of confidence in his ability to lead the firm?

Mathiason et al. (2009, p. 1) observed in LB a “corporate culture that saw professional, knowledgeable risk managers sidelined in the rush to catch a rising market and gain ground on Lehman's pre-eminent rival, Goldman Sachs”. This observation is consistent with Fuld's ambition for continuous growth and a driver in his treatment of employees. Fuld's management style, through his interaction with employees, was characterised by a pattern of squashing dissenting opinion, a very insular view of the world and the hubris to think that he possessed superior knowledge on risk.

10.4.4 Culture Affecting Family

The episodic circuit of power is useful to explain ways in which Fuld and his senior executive team were able to influence staff and their families on a day-to-day basis. The culture of LB and the values of its CEO were imposed on the families of employees. There were rules of behaviour that were expected of employees that also extended to spouses. An example of an event that characterises this feature is described below.

According to Ward (2010) Bradley Jack's wife Karin, recalls a time when she was invited along with other LB executives and their spouses to inspect a house which Gregory, COO was building. Gregory sent his helicopter to pick up the party of executives. However Karin Jack's son had just experienced a seizure and she declined to go, instead insisting she needed to visit a doctor. Notwithstanding Karin Jack's protests, Gregory still landed his helicopter near his guest's home and waited, assuming that the Jacks were still joining the LB group. Karin Jack was quoted as saying: “Can you imagine the pressure? I have this really sick child, but I know that if I don't get on that helicopter it's going to hurt Brad...If you made a personal choice that hurt Lehman, it was over for you” (Ward 2010, p. 133). (Gordon 2010) recognises the dysfunctional culture at LB and the pressure for employees to dedicate a large portion of their lives to the firm:

This company pretended to be united but they were ruthless, they couldn't wait to knife each other in the back. What is really heinous about it is the hypocrisy. This was a place that had a diversity programme that was much lauded, yet they tried to get one guy to go to Asia,

knowing he had a child with cerebral palsy ... In a welcoming ceremony with spouses present, he [Fuld] would thank them for all the cancelled dinners, weekends, and vacations they were about to experience.

Another example involved a direct report of Fuld. As mentioned in section 5.2.3, Fuld placed a great deal of importance on marital harmony, given the experience of Chris Pettit who had an extramarital affair which defied Fuld's inferred rules on marriage (Truell 1997). Pettit's error was compounded as his affair involved a LB female employee which had the potential to tarnish the reputation of the firm. Pettit's dismissal was an exercise of Fuld's power. This power was initially generated in the dispositional circuit by virtue of his hierarchical position and transmitted to the episodic circuit, through the passage point constituted by Pettit's act of breaching Fuld's own values and beliefs which were superimposed on the firm. As a senior executive, Pettit's dismissal would have attracted the attention of the firm at large and would influence the firm's culture by reinforcing the socially constructed rules of the firm reflecting Fuld's own values. The dismissal sent a clear signal to all staff that extra marital affairs would not be tolerated and thus became a 'rule of practice'.

The above examples re-inforce the potency of Fuld's influence within the firm and with those connected to his employees. The evident coercion to behave in a certain manner is symptomatic of the exercise of power of one over another. Employees clearly understood, through their observation or knowledge of the treatment of Jack's wife and the dismissal of Pettit that certain expectations applied to their behaviour. As such events continued, employees formed expectations of their own behaviours in order to survive in their roles. The expectations of behaviour were tantamount to socially constructed rules that informed relations between Fuld and his employees. The fixing of these rules within the firm was the source of Fuld's power in the dispositional circuit. The power would be transmitted through the passage points of internal communications, either in verbal or written form such as a notice of dismissal forwarded by a supervisor to a subordinate. This transmission of power is enabled by the hierarchical structure where supervisors' and subordinates' roles are defined. Ultimately the rules reflected Fuld's expectations of morals and values in his staff which he communicated clearly, whether by the welcoming speech to employees or through actions such as dismissals relating to behaviour inconsistent with Fuld's view of the world. Fuld also manipulated the firm's culture through an employee compensation plan. The following section explains how Fuld's goal of becoming a pre-eminent US investment bank involved the attraction of the best talent available within the market and remunerating them accordingly with a bonus structure which encouraged an aggressive culture.

10.5 Employee Compensation

Nash (2003, p. 6) suggests there are four fundamental variables which dictate the amount of an employee's bonus: "the degree of individual power of the employee; the economic value that is being created; the complexity of that value; and finally, the degree of teamwork required". This section justifies a fifth element, being the personal objectives of the CEO who in LB's case used financial incentives as a means of generating loyalty in order to pursue his growth agenda. This element is similar to the concept of bonding costs in agency theory as the additional cost of incentives assumed by the agent (manager) as a result of attempts to align their interests with the principal (stockholders) and to assure the principal that she/he will not take inappropriate actions to the detriment of the principal. In this case, this concept of bonding costs related to the payment of incentives to employees in order to align employee interests with that of the CEO.

The first of Nash's (2003) factors warrants discussion in this thesis due to its relevance to the investment banking industry. Individual power is described by Nash (2003) as the power an employee possesses in their compensation negotiations with the firm. The negotiating power results from the scarcity of relevant skills available in the market place and the value an employee can generate for the firm. According to Nash (2003, p. 6) "their [investment banks] strategy for allocating the bonus pool was to protect the 'crown jewels' and prevent them from leaving the organisation". 'Hold-up capital' is a term used by Wang et al. (2009), which is similar to the individual power factor proposed by Nash (2003). In this instance, the premium over the average salary commanded by a skilful employee is referred to as hold-up capital which according to Nash (2003) is amplified for employees in the financial services industry.

In instances where competition for an employee's skills is industrywide, the hold-up capital increases further as the consequences for an employee leaving the firm are nullified by alternative employment options. As discussed in section 8.2.7, the investment banking industry has traditionally attracted high achieving and skilled employees who are often in high demand within industry generally. In such an environment relatively high hold-up capital in the form of salary and bonus levels are commonly observed. Figure 141 draws a comparison between the average salary for the US investment banking industry and the average for all non-government industries in the US for 2008.

Figure 141 - Comparison of Investment Banking and All US Industries Salaries for 2008

Salaries Excluding Bonus	Investment Bank- ing Industry	All US Industries (excluding government)	Premium over Total US Average
	USD	USD	
Mean Salary	84,000	42,270	99%
Median Salary	62,250	32,390	92%

Source: (United States Bureau of Labour Statistics 2008)

Nash (2003) ignores the influence of the CEO as a variable which dictates the amount of an employee's bonus. A CEO may have personal ambitions of positioning the firm as a market leader, consequently willing to offer employee compensation well above the market clearing level. This desire could be driven by a range of motivations from market strategy to personal ego, however, whatever the reason, the CEO of a publicly listed corporation would need to exercise a high degree of influence to ensure compensation outcomes are met. From persuading the compensation committee to impelling the Board of Directors to follow the CEO's personal preferences requires a persuasive ability that is usually associated with a position of power.

Fuld understood the advantage of employing top performing staff in an industry where the quality of employees and the tacit skills they possess are considered a valuable resource. In an interview Fuld stated that one of his main strategic objectives was to surround himself with top performing employees. "You can't be afraid that if the people you hire look good, that diminishes you ... if you want to run an 'A' firm, 'B' people can't get it done" (Wharton School of the University of Pennsylvania 2007). Fuld's interest in competing for top performing staff is evidenced by his recommendation to LB's Compensation Committee for compensation levels to be awarded in the 2008 fiscal year which is captured by the Compensation Committee Report (CCR) (Lehman Brothers Holdings 2008f). This annually produced report justifies the recommended level of cash compensation (salary plus cash bonuses) to apply for the firm's group of employees in total. The cash compensation level was expressed as a ratio of total cash compensation proposed to gross revenue achieved for the past year. This ratio was the basis used to determine the ensuing year's compensation for all employees and separated at a divisional level. This formula was known as the Compensation Ratio (Comp Ratio). The key determinant of the total cash compensation proposed factor in the formula included the relative changes in gross revenue and earnings per share for the divisional group and the relative standing of compensation per employee within the same group. Other subjective measures were used such as growth opportunities and general business conditions (Lehman Brothers Holdings 2008f, pp. 2-4). Equity based bonuses were granted in addition to total cash compensation (Lehman Brothers Holdings 2008f, p. 2). Refer to Figure 142 showing the equity compensation granted to employees in 2006 and 2007.

Figure 142 - Equity Awards Granted to Staff as Part of LB's Incentive Scheme

Equity Awards Granted	2006	2007	% Increase
	Shares in Millions	Shares in Millions	
Awarded during the fiscal year	11	38.8	
Adjustments:			
Earned in 2006 but reported in 2007	35	-35	
Earned in 2007 but reported in 2008		50	
Net Equity Awards Granted	46	53.8	17%

Source: (Lehman Brothers Holdings 2008k, p. 6).

The objective variables upon which LB's 2008 Comp Ratios were recommended include data set out in Figure 143.

Figure 143 - Variables Used in Determining LB's 2008 Compensation Ratio

Variables	Goldman Sachs	Lehman Brothers	Morgan Stanley	Bear Stearns	Merrill Lynch
% Change in Revenue 2006 to 2007	22%	10%	-6%	-36%	-67%
% Change in EPS 2006 to 2007	26%	70%	-60%	-89%	-250%
2007 Compensation per Head (USD)	661	332	343	242	248
2006 Compensation per Head (USD)	622	334	324	320	300

Source: (Lehman Brothers Holdings 2008f, p. 3)

An important feature of the CCR was the relative standing of LB's Comp Ratio with those of its peer group including a comparison of 2006 and 2007 Comp Ratios of all major US investment banks in order to justify a Comp Ratio that would secure top performing staff (Lehman Brothers Holdings 2008f, p. 3). Figure 144 outlines a comparison of the Comp Ratios contained in this report.

Figure 144 - Comparison of Compensation Ratios of US Investment Banks – 2006/2007

	Goldman Sachs	Lehman Brothers	Morgan Stanley	Bear Stearns	Merrill Lynch
2007 Comp Ratio	43%	49%	59%	57%	141%
2006 Comp Ratio	44%	49%	47%	47%	49%

Source: (Lehman Brothers Holdings 2008f, p. 3).

For the 2008 fiscal year Fuld recommended to the Compensation Committee a Comp Ratio of 52.8%, placing it at a level above the 2006 Comp Ratios of all peer group members even though it represented a level below those recorded by the peer group in 2007 (Lehman Brothers Holdings 2008f, p. 2). At the recommended level it would also result in a 5% increase in compensation per employee for 2008 (2007: -1%). Fuld feared that any Comp Ratio selected for 2008 which was below that of its nearest competitors' 2006 Comp Ratio could generate a flight of key staff. LB's 2007 Comp Ratio of 49% seemed out of line with

that of its competitors and was the second lowest of its peer group. The relatively low Comp Ratio in 2007 was acknowledged by Fuld as a means of maintaining discipline (Lehman Brothers Holdings 2008f, p. 2). However this lower Comp Ratio was offset by a 17% increase in long term stock awards for the same year – refer Figure 142. Only the most senior of executives were awarded stock incentives, therefore despite the Comp Ratio remaining relatively low for 2007, senior executives, including Fuld and his direct subordinates, were able to achieve an increase in the combination of short term and long term incentives from the previous year.

Fuld's 2008 recommendation argued the importance of surpassing anticipated 2008 Comp Ratios of LB's competitors as an opportunity to keep talented staff members and to attract other leading operatives in the industry. Fuld's objective was for:

repricing key talent to retain at Lehman if bid away... and to take advantage of a significant pool of talent [which] will become available, as many of our competitors top performers become disillusioned with their firms' strategies and risk management (Lehman Brothers Holdings 2008f, p. 2).

The reference to disillusionment with risk management is an inference to LB's higher appetite for risk relative to the peer group and therefore an environment where potential new high performing staff could increase their bonuses. The propensity to award equity based compensation to employees is evidenced by the growth in employee ownership of the firm since its incorporation. "When the firm went public, employees owned four per cent of the firm, worth USD 60m. By 2006, they owned around 30 per cent, equivalent to USD11billion, at least on paper" (Oliver & Goodwin 2010, p. 80). A lucrative employee compensation structure is often viewed as the most effective incentive available. Fuld remunerated top performers who exhibited entrepreneurial traits and those who showed inclinations for risk taking (McDonald & Robinson 2009). This is supported by the firm's stated strategy originated in 1994 which encouraged an alignment of compensation with the maximisation of returns:

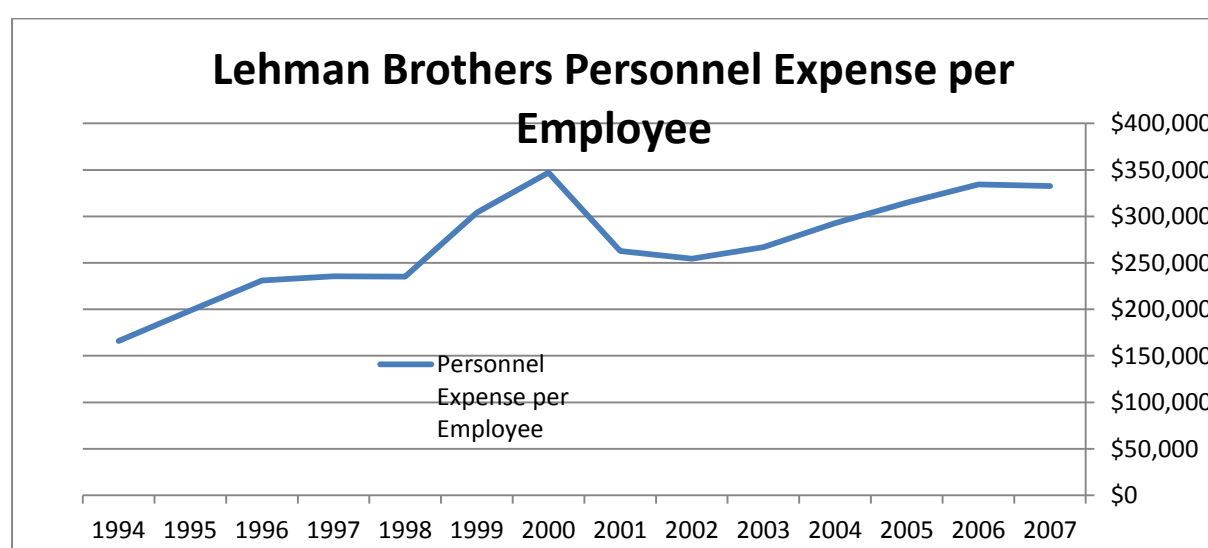
Lehman Brothers' human capital strategy is to attract and retain the most talented employees and to strongly align their interests with maximizing Company performance and stockholder return. Our strategy regarding our employees has remained consistent since becom-

ing a public company in 1994 and, we believe, has been instrumental in helping the Company achieve its goals over time (Lehman Brothers Holdings 2008i, p. 19).

Although the concept of linking compensation to the maximisation of returns is not unusual from an agency perspective, there is no mention of achieving an acceptable level of risk in the quote above or in any other official documentation describing LB's compensation policy.

From the time he became CEO and Chairman in 1994 to the time LB filed for bankruptcy on September 15, 2008, Fuld presided over an increase of personnel expense per employee⁸⁷ of 100% - refer Figure 145 for a graph showing the escalation of expense per employee between 1994 and 2007.

Figure 145 - Lehman Brothers Personnel Expenses per Employee 1994 - 2007



Source: The data used for the graph was extracted from from Lehman Brothers Holdings (2008f, p. 5).

A further analysis of the trend in personnel expenses is gauged by the proportion they constituted of the firms performance indicators of net revenue and net profit after tax. Refer

⁸⁷ Personnel expenses include employee salaries plus cash bonuses but excluding stock based awards.

to Figure 146 for a table of the relative attribution of employee expenses to these performance indicators.

Figure 146 - Employee Expenses as a proportion of Net Revenue and Net Profit After Tax

	2006	2007
	USD Millions	USD Millions
Net Revenue (after interest expense)	17,583	19,257
% Increase from 2006 to 2007		10%
Net Profit After Tax (NPAT)	3,941	4,125
% Increase from 2006 to 2007		5%
Employee Expenses (EE)	8,669	9,494
% Increase from 2006 to 2007		10%
EE/NPAT	220%	230%
EE/NR	49%	49%

Source: (Lehman Brothers Holdings 2007, p. 85).

The increase in personnel expense per employee is consistent with the increasing proportion of personnel expenses to net profit after tax, increasing from 220% in 2006 to 230% in 2007. Personnel expenses were also able to track the significant increase in LB's Net Revenue (gross revenue less interest expense) whereby it remained at 49% of net revenue from 2006 to 2007.

Fuld advanced his career mostly in a trading environment where problem solving skills and an aggressive risk taking attitude are considered positive attributes. He therefore appreciated personnel who displayed these same attributes in a business where financial outcomes are transparent and easily measurable (McDonald & Robinson 2009). His preferred means to motivate staff was through an employee compensation structure which grants equity in the firm. "One of the most important elements of Fuld's plan to develop a culture of teamwork at Lehman Bros. has been to link compensation to the overall performance of the firm through equity awards" (Wharton School of the University of Pennsylvania 2007). Fuld also understood that to motivate staff to pursue higher performance they needed to think like stockholders. "A culture built on teamwork leads to the best business decisions for the firm as a whole, and paying employees in stock helped reinforce that culture, I wanted them all to think and act and behave like owners" (Wharton School of the University of Pennsylvania 2007). Consistent with Jensen & Meckling's (1976) agency theory maxim of 'management's objective to maximise stockholder wealth', Fuld ensured senior management accumulated a

significant portion of equity in LB. As stockholders, management were incentivised to take risks so long as Fuld's optimistic view regarding the economic environment prevailed and the firm's risk limits allowed. It was therefore important that if Fuld wanted to motivate staff, and generate the desired level of 'bonding', senior management were to be allowed to operate within flexible risk limits and possess a large amount of equity. As equity awards were vested on an average of 3.8 years as mentioned below, Fuld intended to hold onto good performers for the long term (Lehman Brothers Holdings 2008i, p. 32).

LB operated a number of equity based incentive compensation schemes which Fuld used to incentivise staff and which applied to the senior executive team including Fuld. Equity incentives accounted for the bulk of the senior executives' overall compensation. "Fuld, Gregory, Russo, O'Meara and Lowitt received 88%, 85%, 64%, 70% and 70% respectively of their total annual compensation in equity. The weightings of cash and equity were determined collaboratively by Fuld, Gregory and the Compensation Committee" (Lehman Brothers Holdings 2008k, p. 4). Whilst the stock price of LB climbed, these senior executives' wealth increased dramatically. According to Lehman Brothers Holdings (2008k, p. 4), LB stated that "the repurchase program has prevented stockholder dilution, while allowing the Firm to benefit from the employee commitment generated by broad based employee ownership". This public comment seems to justify the relative high level of stock award bonuses paid to senior executives by assuring stockholders that their value of stock had remained unaffected by the bonuses, thereby abiding by the firm's code of ethics.

These equity based incentives are in addition to the abovementioned personnel expenses (Lehman Brothers Holdings 2008f). According to Lehman Brothers Holdings (2008i, pp. 25-7), for the year ended 30 November 2007, LB expensed incentive costs of USD 1.3 billion related to these equity based incentive schemes, up from USD 1.0 billion in 2006 – representing a substantial 30% increase. Excluded from this amount was another expense of USD 514 million which related to stock awarded to employees during the month of December 2007. This additional stock based compensation was accrued as compensation expense in the financial year ending 30 November 2007 as it was argued it related to staff performance during fiscal 2007. Therefore the total amount of stock incentives awarded during the 2007 fiscal year had reached USD 814 million, which was over and above the cash compensation allocations. Stock incentives which had not vested as at 30 November 2007, and therefore remained unrecognized in the financial statements totalled USD 2.0 billion. This amount, included in the notes to the LB 2007 annual report, was expected to be expensed over a weighted-average period of 3.8 years. This was in accordance with the vesting provisions and with the prevailing accounting treatment for stock based compensation found in accounting standard Accounting for Stock Based Compensation - FAS 123, prevailing in 2007/2008 (Financial Accounting Standards Board 2004).

A major portion of the firm's incentive based compensation was awarded to Fuld and his team of senior management Lehman Brothers Holdings (2008i, pp. 25-7). Although the details of the formula used for Fuld and his direct subordinates is not disclosed, LB acknowledges that it was based on a percentage of pre-tax profit. "The Fiscal 2007 incentive formula for each executive officer was based on percentages of Pre-tax Income, which percentages decline as the amount of Pre-tax Income increases up to USD 5.3 billion (beyond which the percentage is fixed). The incentive formula is expected to yield a bonus payment, except in the event of a loss" (Lehman Brothers Holdings 2008i, p. 24). The rates on the sliding scale are not disclosed. However the maximum percentage at the end of the sliding scale payable to senior executives once the target of USD 5.3 billion is reached is shown in Figure 147 .

Figure 147 - Senior Executive Incentive Scheme Formula

Executive Name	Maximum Percentage of Pre-tax Profit
Richard Fuld	0.75%
Joseph Gregory	0.57%
Tomas Russo	0.50%
Christopher O'Meara	0.25%
Ian Lowitt	0.25%

Source: (Lehman Brothers Holdings 2008i, pp. 25-7).

According to Lehman Brothers Holdings (2007, pp. F-10), LB's pre-tax profit of USD 6.01 billion for 2007 exceeded the threshold of USD 5.3 billion, thereby enabling each senior executive to receive their maximum compensation payment at the rates depicted in Figure 147. In establishing the above formula, Fuld with the assistance of the Compensation Committee established key performance objectives for his executive team. These objectives were intended to drive the team to pursue Fuld's growth strategy and included:

expanding the firm's international franchise; strengthening the Company's brand; exploring and creating strategic opportunities; diversifying and building business units; improving employee programs; and the firm's budgetary goals (Lehman Brothers Holdings 2008i, p. 25).

The compensation paid to the senior executive team for the year ended 30 November 2007 is shown in Figure 148.

Figure 148 - Senior Executive Compensation - 2007

2007 LB Executive Compensation					
Executive		Salary USD	Cash Bonus USD	*RSUs USD	Total USD
R. S. Fuld, Jr.		750,000	4,250,000	35,000,000	40,000,000
J. M. Gregory		450,000	4,550,000	29,000,000	34,000,000
T. A. Russo		450,000	4,550,000	9,000,000	14,000,000
C. O'Meara		200,000	2,650,000	6,642,857	9,492,857
I. T. Lowitt		200,000	2,650,000	6,642,857	9,492,857

Note: *RSU's = restricted stock unit awards

Source: (Lehman Brothers Holdings 2008i, p. 26).

Fuld's own compensation was set by the Compensation Committee. Key factors taken into consideration in formulating his compensation included the same objectives used for the senior executive team mentioned above, in addition to projected and historical financial performance as well as the following as stated in LB's Schedule 14A Statement lodged with the SEC on 5 March 2008:

the firm's financial performance in Fiscal 2007, his role in leading the Company through the challenging market environment, and orchestrating the Company's strategic direction and objectives including the continued diversification of the Company across businesses, regions and products which was important to the Company's financial performance in Fiscal 2007 (Lehman Brothers Holdings 2008i, p. 26).

The above shows that there is a focus in Fuld's compensation criteria to pursue growth and diversification. Fuld pursued both, including his continued push for acquisitions as described in section 6.3.2. According to information included in SEC filings governed by the Code of Federal Regulations⁸⁸, the top five executives at LB received substantial bonuses as part of their overall compensation arrangements for the period 2000 to 2008. The group of executives included in the top five changed slightly from year to year and as identified by SEC filings included: "Richard Fuld, CEO from 1993 through 2008 and chairman of the Board from 1994 through 2008; David Goldfarb, CFO from 2000 through 2004 and CAO from 2004 through 2006; Joseph Gregory, co-COO from 2002 through 2008 and COO from 2000 through 2002; Christopher O'Meara, CFO from 2004 through 2007 and previously in various management positions at the firm (since 1994); and Thomas Russo, CLO from 1993 through 2008. Fuld and Gregory were NEOs throughout the 2000-2008 period, Russo from 2003 through 2008, Goldfarb from 2004 through 2007, and O'Meara in 2007 and 2008" (Lehman Brothers Holdings 2008h, pp. 14-8). In aggregate the group "earned approximately USD 1 billion, in cash bonuses and equity sales during 2000-2008" (Bebchuk et al. 2010, p. 4).

⁸⁸ The Code of Federal Regulations requires full disclosure of all components of compensation received by the top executive officers of a corporation.

An example of the preparedness of the Compensation Committee to reward Fuld was during the major US financial crisis of 2001. As a result of the financial crisis, most investment bank CEOs including those at Goldman Sachs, Morgan Stanley, and J. P. Morgan Chase, had their compensation packages reduced. At the same time, LB which outperformed the industry rewarded Fuld with a compensation package valued at USD 105 million representing the fourth highest for a US CEO in 2001 (Reference for Business 2017). The awarding of this exorbitant level of compensation is despite LB recording a significant reduction of 30% in net profit after tax from 2000 to 2001 as shown in Figure 149.

Figure 149 - Net Profit After Tax for Fiscal Years 1999, 2000, and 2001

	2001 USD million	% Change	2000 USD million	% Change	1999 USD million
Net Profit After Tax	1,161	-30%	1,667	61%	1037

Source: (Lehman Brothers Holdings 1999, p. F2; 2002, p. F2).

Comparing the returns of the senior executives to stockholders over the period 2000 to 2008 reveals an incentive problem inherent in the compensation arrangements at LB. The problem relates to the absence of a risk adjustment mechanism within the performance-based compensation of LB employees and senior executives. Risk adjustment could entail the profiling of the risk of the firm using a variety of techniques including alignment with balance sheet risk (as measured by leverage), credit ratings, stock beta⁸⁹, or a combination of several measures. Further, a large portion of bonuses could have been calculated retrospectively. Retrospective bonus payments could allow sufficient time to ensure current business written did not cause subsequent losses in future periods. In these instances, bonuses could be withdrawn thereby aligning compensation with sustainable business performance. Whilst LB included a deferred stock component in the compensation plan for employees and senior executives, some of this stock could not be withdrawn except in certain employment termination cases. The deferred stock plan was intended to retain employees over the medium term rather than provide a risk adjusted incentive. Further, none

⁸⁹ A stock's beta is a measure of the stock price volatility around the mean of the whole market return. Therefore it is a proxy for the risk of a stock's returns.

of the independent directors were compensated on a risk adjusted basis (Lehman Brothers Holdings 2008i, pp. 14-26).

Rational stockholders according to Modern Portfolio Theory⁹⁰ undertake investments based on a trade-off between expected risk and return. Consistent with this theory, as LB's performance deteriorated, the value of LB's shares decreased accordingly, ultimately resulting in a complete loss of value by the time of bankruptcy. However as mentioned above, during the final years of LB, the senior executive team were rewarded handsomely, with performance based compensation of approximately USD 1 billion. The difference in compensation between stockholders and LB executives implies that "the executives' pay arrangements provided them with excessive risk-taking incentives" (Bebchuk et al. 2010, p. 4). Any sign of deterioration in net profit would have resulted in lower stock compensation therefore it would have been in management's interest to avoid publishing a decline in net profit after tax – the key determinant of stock awards. Further as Modern Portfolio Theory suggests, there is an incentive for executives to increase risk if they seek higher returns.

The disparity between stockholder and executive returns is explained by the flawed compensation plan which neglected to adjust bonuses for the underlying risk carried by the relevant business unit or employee. The need for a consistent approach to the linking of risk to compensation was acknowledged in the aftermath of the GFC. "A risk-sensitive compensation framework provides the appropriate incentives for employees, and establishes a superior link between the actions of those employees and the firm's overall risk profile" (Kroszner 2008). The absence of a risk-sensitive compensation framework led to risk-taking behaviours in an effort to maximise bonus levels. The year on year expectation of abnormally high bonuses, generated a culture of excessive risk taking in order to maximise short term profits. Downside risk to the employee was minimal. Employees were not required to repay bonuses once awarded if performance in the ensuing period erased all the gains of the period on which the bonuses were calculated (Bebchuk et al. 2010). At worst the employee would be terminated, however given the scarcity of skills in the investment banking industry during that same period, the consequences for an employee was deemed relatively immaterial.

⁹⁰ One of the main aims of Modern Portfolio Theory is to construct an optimal portfolio by maximising returns whilst minimising risk.

As mentioned above in this section, Fuld understood the advantage of employing top performing staff in an industry where the quality of employees and the tacit skills they possess are considered a valuable resource. As a service industry which relies heavily on the performance of its employees, the investment banking industry generally values an effective compensation framework. The effectiveness of a compensation framework in an industry which also deals with significant risks needs to balance the performance of the individual with the risks they incur for the firm. This is particularly noted within the risk management profession:

An effective risk-sensitive compensation regime, properly embedded in a strong strategic risk management framework, can generate changes in behaviour so that the firm's employees refrain from taking on risk beyond the firm's stated risk appetite. Most importantly, such a compensation regime must offer the appropriate incentives to assume appropriate level of long term and short term risks during various economic cycles (Kroszner 2008).

LB awarded especially attractive compensation ratios during the period between 2004 and 2006. Refer Figure 144 showing LB as offering the second highest compensation ratios of its peer group. "LB's Compensation Committee cited record net revenues, pre-tax income, net income, and earnings per share, as well as an increase in the firm's share price of 17% during the fiscal year 2006, in its decision to award bonuses for fiscal year 2006" (Bebchuk et al. 2010, p. 267). The use of only one year's performance, in this case that of 2006, supports the view that the Compensation Committee was using short term performance as its primary performance indicator for the establishment of a particular year's incentives.

Therefore we can partly disassociate LB's incentive scheme from the long term risk-related decision-making process compatible with the long term interests of stockholders. Risk-related decisions were taken without the benefit of foresight of an impending collapse. However Fuld wouldn't be paying large incentives unless there was a return to the firm or himself. Short term incentives can create more immediate and self-serving behaviour which suited Fuld in a fast paced industry which is characterised by pressure to generate good results on a quarterly basis, and a reactive share price.

The excessive compensation arrangements also attempted to create teamwork and a consensus view of the direction of the business (Nash 2003). Serwer (2006) quotes Skip McGee, a previous head of investment banking as saying: "Instead of trying to divide fees up and allocate them to different bankers and departments, for purposes of compensation calculations, we just double-count revenues". Although this practice inflated the basis of bonus calculations due to the 'double' counting of team and individual bonus allocations, it had incentivised employees to help one another, supporting the group capture by Fuld of the loyalty of his employees and fuelled a transaction oriented investment banking operation. LB employees were driven by the same forces which drove Fuld's own self-interest, thereby enabling Fuld to inculcate the culture of the organisation with his own values and beliefs. It

could be said that Fuld was 'drinking out of the same trough as staff' and his entrenched and shared belief system within the firm could explain the unusual loyalty he generated. In enriching his staff, he was able to enrich himself.

This chapter supports the case that excessive optimism as mentioned above, combined with a behavioural pattern shaped by a culture highly influenced by the CEO created an elevated state of hubris at the core. The hubris of the CEO and the power he exerted over employees and the board infected the decision-making of key executives who had a genuine interest in the survival of the firm and the continuation of their careers. At the centre of the hubris was Fuld's faith that the power of the CEO and the firm would overcome any obstacles faced. The following section illuminates the culture of LB by exploring the rhetoric used in certain communication devices used by the firm such as presentations and internal emails. The following section analyses these forms of communication and how they elucidate a dysfunctional culture which led to irrational decision-making. By influencing culture, Fuld exercised power over employees with the aim of encouraging conformity of values and beliefs with his own.

10.6 Communication as a Window on Corporate Culture

Communication through language establishes meaning within an organisation. The language can be conveyed either verbally, in print, or physical expression, such as a frown. Meanings can affect the culture within by establishing expectations of behaviour as explained in the previous section. In return, culture can have an effect on meanings, as a particular use of language can be interpreted differently by different cultures. Cultures can be influenced especially if the language emanates from an organisation's leadership who possess power over behaviour (Eccles et al. ; Westbrook 2013). Westbrook (2013, p. 57) establishes the nexus between communication and culture and asserts that "one cannot think of communication (one cannot speak) outside of a culture". Therefore selecting the language and the environment in which it is delivered to express expected morals, values and beliefs is deemed an important method of shaping a culture of an organisation. This chapter finds that Fuld's internal and external communication, a key trait of his management style, also contributed to the intensification of a culture which began with the founders of the firm and perpetuated by successive leaders throughout the history of the organisation. The communication represented passage points through which Fuld was able to transmit power which ultimately was exercised in his day to day dealings with his staff. This section analyses certain examples of communication used at LB and covers formal visual presentations, verbal and email communications. Rhetoric, including the tones and underlying meanings within

the language used is analysed to illuminate the direct and underlying messages conveyed to employees by the senior leadership of the firm.

Fuld avoided direct contact with employees: “our battlefield commander[Fuld] was an extremely remote and watchful character surrounded by a close coterie of cronies, with almost no contact with anyone else” (McDonald & Robinson 2009, p. 90). This type of introverted behaviour exemplified by remoteness from employees was Fuld’s preferred *modus operandi*. It was clear that Fuld made the key decisions whilst using his immediate subordinates to communicate them to the general staff. “The environment had become so insular... Fuld OK’d decisions, but Gregory packaged material so that the choice was obvious. And the executive committee offered no counterweight” (Fishman 2008, p. 5). Fuld was CEO of one of the major US investment banks with a staff complement of 25,000, and total revenue of over USD 53 billion (Cook 2009). Many CEOs of large corporations prefer to circulate amongst employees to gauge feedback and monitor operational issues including staff morale. Avoiding direct communication with the wider staff, Fuld needed alternative channels to convey his messages as outlined below.

10.6.1 Rhetoric in Key Strategy Document

In 2006, one year before the deterioration in LB’s performance, Fuld and Goldfarb Chief Administrative Officer (CAO), delivered the firm’s global strategy at an offsite conference for senior executives using a slide presentation, known as the Global Strategy document (Lehman Brothers Holdings 2006). This is a key document as it presented LB’s strategy for the three years up to 2009. It can therefore be viewed as the guiding template used by management to execute their operational and strategic decisions immediately prior to the firm’s bankruptcy. It represented Fuld’s vision and objectives for the firm. Of interest, is how Fuld communicated his vision and objectives, which metrics and concepts are included, and just as importantly, which are excluded from this narrative. One of the tenets of this thesis is that Fuld pursued a growth strategy at all costs. The Global Strategy document reinforces this growth agenda in a variety of ways. An examination of the rhetoric used reveals intent to convey the ‘growth’ message to all senior executives in a way that strongly influences compliance to Fuld’s agenda.

Rhetoric is a useful tool to influence others to the “viability, credibility and plausibility of...positions, beliefs, problems solutions and perspectives” (Young 2003, p. 623). The Global Strategy document was written in such a way as to persuade the audience consisting of senior executives to follow and understand the stated path of ‘growth’. Although some of the persuasive elements within the document are subtle, a rhetorical analysis reveals how they establish meanings, communicated in a way that could be clearly understood by the intended audience. The selection of certain words, were intended to assist in this persuasive pro-

cess and according to Summa (1992, p. 138), to construct a power “to change the world, giving rhetoric both philosophical and political importance by demonstrating its connections with forces that shape reality”.

The Global Strategy document comprises 38 slides. The communication style incorporates dot points and punchy sentences presented with colour and many statistics, figures, graphs, and financial terms which could only be understood by those with a professional financial background. This style of communication would appeal to the audience who, as senior executives of an investment bank, would have shared similar backgrounds. Operating in a time poor environment, the style suited their use of day to day communication. In this environment where efficiency is rewarded, any tool which saves time, such as clear, economical and concise communication would be deemed preferable. Immediately, the appeal of the mode of communication would have the effect of engaging the audience.

The content of the slide presentation is divided into two parts: the first part detailing the historical record of achievement to date [2006], including measures dating back to incorporation in 1994 (refer below for discussion about comparatives used); and the second part outlining the future strategy for the ensuing three years. The introduction page of the whole document is set out in Figure 150.

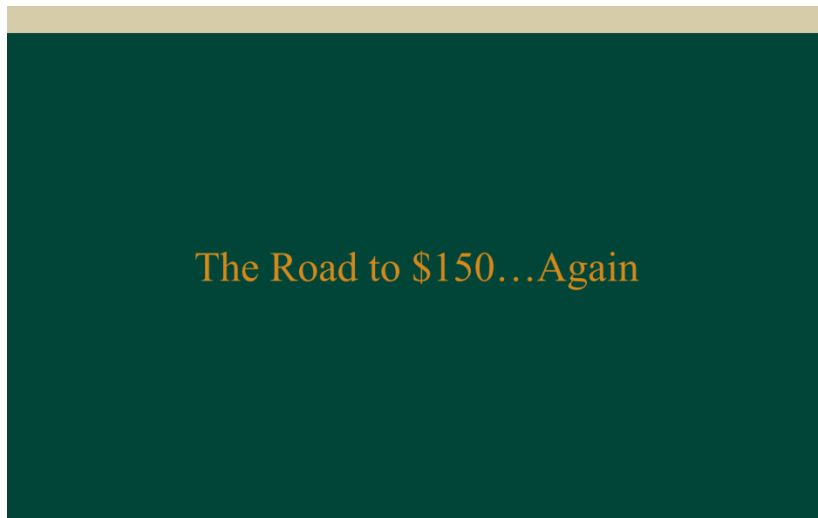
Figure 150 - Introduction to Global Strategy Presentation March 2006



Source: (Lehman Brothers Holdings 2006, p. 2).

The first page of the second part of the presentation dealing with forward looking strategy is set out in Figure 151.

Figure 151 - Introduction to Future Strategy Section of Global Strategy Presentation March 2006



Source: (Lehman Brothers Holdings 2006, p. 22).

The reference to '\$150' applies to the stock price of LB in both the introduction to the whole presentation and to the introduction of the future strategy section. The stock price of USD 150 is after the stock split on 23 October 2001 when the stock was split 2:1 and the price decreased from USD 125.50 to USD 62.50. The document was presented in March 2006, when the share price hovered around USD 141. The focus in the Global Strategy document was clearly on the firm's stock price. Reference to the stock price was included in four pages out of the first 6 pages and continued throughout the document. Therefore the implied strategy was focused on the firm's stock price above all other measures. Even though this measure of management performance is not unusual for a publicly listed corporation, occupying such a prominent position as an objective has meaning. Not only did management want to maximise stockholder wealth in accordance with agency principles, the maximisation of stock price also translated to the maximisation of the bonus components of employee and senior executive compensation (refer section 10.5 for further discussion on employee compensation). This is consistent with the notion of senior executive self-interest expressed throughout this thesis.

The other feature of the document was the reference to the word 'growth'. This term appeared in 9 slides out of the 15 slides devoted to the future strategy section. Moreover 'growth' was included as part of the heading of seven out of the 15 slides in this section. The word 'upside' used in the context of 'growth' was used in a further two slides. The introductory summary page of the future growth section appears in Figure 152.

Figure 152 - Introductory Summary Page of Global Strategy Presentation March 2006

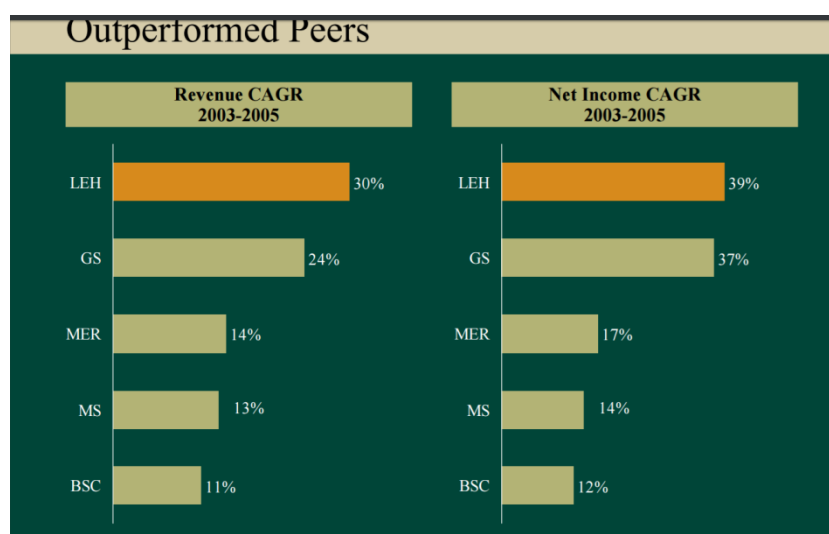


Source: (Lehman Brothers Holdings 2006, p. 23).

The summary page of the future strategy of the firm clearly emphasises the intention for growth and relates this element to the drivers expected for the ensuing three years. The expectation of growth in the global capital markets and economy is a forecast and merely represents the firm's own view on which the whole future strategy is based. There is no mention throughout the document of contingencies if such growth did not occur. Therefore it could be surmised that the firm's strategy was based on a singular optimistic view of the future external environment. This is another example of the hubris exhibited by senior management where no consideration was given to an alternative scenario as evidenced by the document.

The preoccupation of comparing itself to its peer group is evident in the document. Reference to a peer group comparison appears in approximately a third of the slides in the presentation. As mentioned in section 10.2.5, LB was subject to a normative influence which caused it to monitor its competitors' performance and activities. Any significant deviation to the peer group's financial performance, corporate structure, divisional activities or modus operandi could risk an 'outlier' result and attract unwanted scrutiny. Peer group comparisons also sought to legitimise past management decisions, particularly if the firm outperformed the peer group as shown in some of the slides. An example of the narrative in this regard is shown in Figure 153.

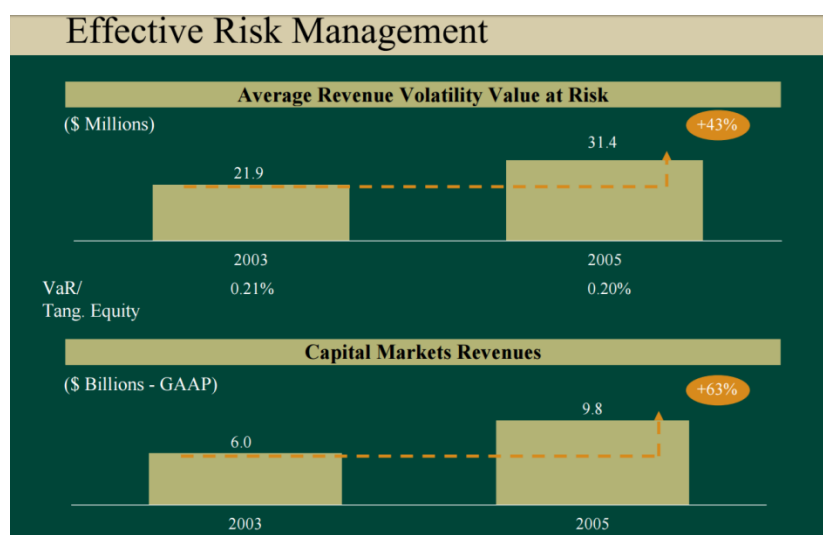
Figure 153 - Peer Group Comparison 2003 – 2005.



Source: (Lehman Brothers Holdings 2006, p. 5).

Figure 153 depicts LB as the standout performer based on compound average growth in revenue and net income compared to its peer group. However two issues are important. Firstly the selection of the period coincides with a leading CAGR. If other periods were selected, the CAGR would have not been as attractive. Secondly, there is no measure indicating this performance relative to risk. There is only one slide in the whole presentation dealing with risk which is set out in Figure 154.

Figure 154 - Risk Management Measures of LB 2003 - 2005



Source: (Lehman Brothers Holdings 2006, p. 17).

This slide dealing with the firm's risk management is telling in that it uses only one measure of risk – Value at Risk (VaR) which is described below. LB's business involved trading in secu-

rities and debt which included loans. VaR is only useful in measuring risk on a portfolio of market priced debt and equity securities and is inapplicable to illiquid loans or other credit exposures within the balance sheet. Many of LB's investments were included in Special Purpose Vehicles (SPV) which were standalone corporate entities outside the consolidated group over which LB exercised control. Shares in these SPVs were not quoted and therefore they represented illiquid assets which relied on management's assessment of value for inclusion in any VaR calculation.

VaR is mostly used as a measure for risk associated with a securities portfolio where the measure is calculated using a sample of historical market price movements. The VaR model is a probability based model and therefore is a statistical measure dependent on arbitrary selection of variables. It measures the potential for loss, not the actual loss of a firm, by assessing the probability of loss (for example a 1 in 20 day occurrence) and the time frame - often used in one year time intervals. Therefore longer term measures are usually ignored. Further uncertainty surrounding this measure includes no definitive approach in selecting the variables in question to determine the appropriate level of risk to be tolerated. For example, when selecting a time period for analysis of the probability of loss, the sample selected may include data obtained from a period of low volatility. This would result in a more conservative risk measure than if the sample period covered a more volatile period. As this is a means based measure of volatility, extreme events are generally ignored when assumptions of normal distribution probabilities are used. Also as a mark-to-market based measure which relies on market prices, it encounters difficulty when market prices are unavailable such as during a financial crisis.

The risk management slide ignored other risk metrics applicable to LB's balance sheet such as leverage, capital adequacy or a measure of credit risk using traditional credit risk metrics such as ratios relating to problem and past due loans, bad debts and credit risk grading within the investment and loan portfolio. The use of the VaR model as opposed to any other risk model reinforces the trading mentality of the firm. This cultural trait can be observed as far back as the founding of the firm when the Lehman brothers traded a variety of goods including commodities such as cotton which were subject to market price risk. Additionally

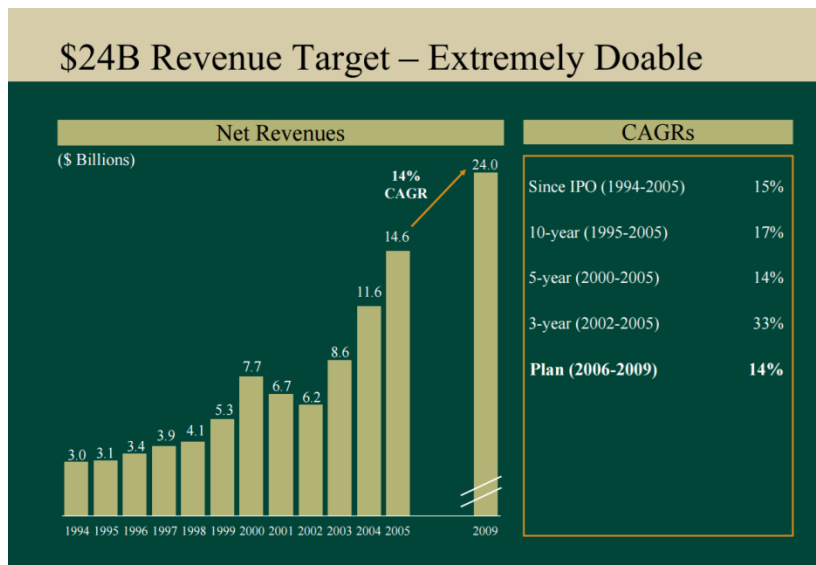
given the VaR model was a recently used measure in the financial markets⁹¹, many executives may not have been familiar with the concept.

The slide takes into account the effect on revenue from a potential downside movement in market prices relevant to LB's portfolio using a sample of historical data. This level of expected loss was quantified as USD 21.9 million in 2003 and rising to USD 31.4 million in 2005. The other reference to VaR is its expression as a percentage of tangible equity which remained stable from 0.21% in 2003 to 0.20% in 2005. These latter statistics are intended to show that although the absolute level of VaR increased, the firm was able to contain it at a constant level relative to tangible equity. The effect was to allay any fears of the audience that the firm was unduly increasing its risk profile. Importantly, the slide does not include any assumptions of the variables used in the VaR calculation as mentioned above. For example a time frame covering a period of low volatility would have produced a relatively lower VaR. Therefore, the one page slide devoted to risk management could be considered an abbreviated representation of the firm's risk profile using a narrow measure intended to downplay the level of risk incurred by the firm.

The use of particular words such as 'Extremely Doable' in the headings of another two slides involved in the setting of revenue and stock price targets, again establishes an expectation that the targets are entirely realistic. Refer to Figure 155 and Figure 156. There is no doubt in the message conveyed by the word 'Doable' as it relates to the audience in a colloquial form, and as it is separated by a colon from the first part of the heading, appears highlighted as a message on its own. The consequent attention to this phrase creates the perception of it constituting a 'command' rather than a 'suggestion'. The implied message is that the targets are easily achievable and the underperformance to this target would be deemed a failure by any team or individual in carrying out their role. Fear of failure to this expectation, is used as a motivator at least, and a coercive pressure at worst. Therefore the communication of the slide during the offsite meeting is considered a passage point between the dispositional circuit where the rule of practice of performing to an expected target is formed, and the episodic circuit where the day to day activities of staff are directed to achieving the targets.

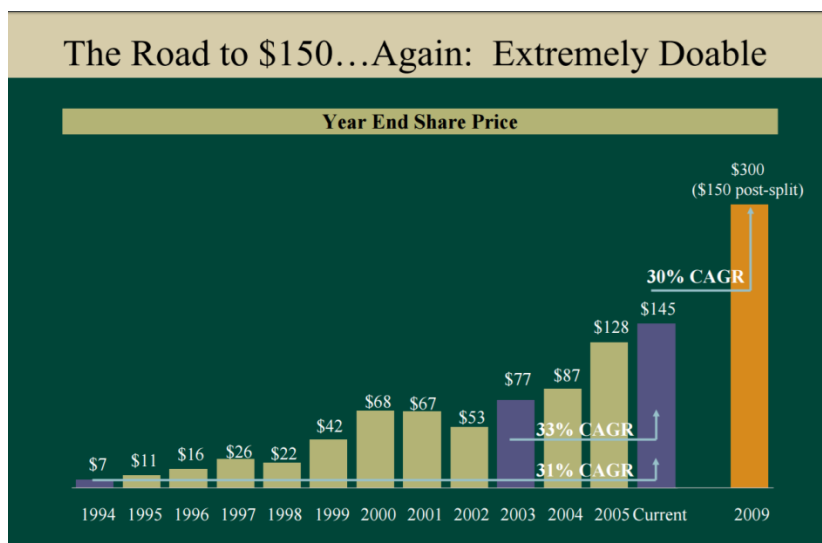
⁹¹ VaR was not popularised until the 1980s and its use was triggered by the stock market crash of 1987. (Wipplinger 2007).

Figure 155 - Revenue Target for 2009



Source: (Lehman Brothers Holdings 2006, p. 34).

Figure 156 - Stock Price Target



Source: (Lehman Brothers Holdings 2006, p. 37).

Figure 156 is important as it also shows the actual CAGR used by LB to depict an exceptional performance by the firm. However there appears a discrepancy between the CAGR depicted in the slide and the CAGR calculated using the standard formula used for calculating CAGR which is presented in Figure 157:

Figure 157 - Standard Formula for CAGR

$$CAGR = \left(\frac{\text{Ending Value}}{\text{Beginning Value}} \right)^{\left(\frac{1}{\text{No of Years}} \right)} - 1$$

A comparison of the results between the calculation of CAGR using the above standard formula and percentage shown on its slide are presented below:

Figure 158 - Comparison of CAGR Calculations for LB's Stock Prices

Calculation Method	Period	Period		Period	
	Column 1	Column 2	Column 3	Column 4	Column 5
	1994–2006 (current)	*2003–2006	*1994-2006	*2006 - 2009	*1994-2009
Shown by LB	31.0%	33.0%	33%	30.0%	30%
Actual using formula in Figure 157	28.7%	23.5%	28.7	27.4%	28.5%
Difference	2.3%	9.5%	4.3%	2.6%	1.5%

Note: * There is ambiguity in the slide as to whether the CAGR in these columns are calculated using 1994 as the beginning value, or 2003 and 2006 as shown in columns 2 and 4 respectively. Therefore calculations for both periods have been shown to avoid doubt.

The difference between the LB version of CAGR and that calculated by the standard formula varies. The differences in all circumstances represent an overstatement by LB which are in a range of 1.5% to 9.5% depending on the beginning periods used. This is either due to a mistake in LB's calculation process, the use of data different to that provided in the slide, or worse still an intentional attempt to mislead the audience. Either way, the information in the slide is misleading with the LB version exceeding the correct calculation in every period used. If management's purpose was to create a misleading perception, this unethical practice could have been driven by two different motives depending on the period covered.

For historical data, the intention could have involved the creation of a perception that management had been very successful, thereby instilling extra confidence and loyalty in the firm's leadership. The overstatement of the forecast CAGR to 2009 could have resulted from a rounding up to the nearest multiple of 10 so as to provide a clearly understood CAGR target that the senior executives could easily remember and act upon. A simply stated objective would assist in its achievement. If this scenario was the case, Fuld would have been complicit in managing perceptions in order to achieve a stretch target. This manipulation

can be interpreted as an exercise of power created in the dispositional circuit where the expectations of performance are clearly established as a rule of the firm. Consequently, the failure to achieve the target even one that was stretched, could attract negative outcomes for the staff member. As mentioned above, the communication of this slide represents a passage point from which the power generated in the dispositional circuit was transmitted to the episodic circuit for the effective implementation of the necessary tactics to achieve the targets.

Fuld's attempt to extend the 'growth' culture throughout the firm can be observed in Figure 159. The title of this slide refers the intention to sustain the high growth rates of market share for the firm. Highlighted as a key to achieving this growth is the phrase "Aggressively grow and diversify our franchise and strengthen our capabilities" (Lehman Brothers Holdings 2006, p. 31). The key word 'aggressively', apart from describing the growth target for 'new initiative' investments, is not quantified with reference to the other items earmarked for growth. Resources for balance sheet, capital and risk appetite, have not been identified either. Importantly growth intended for 'risk appetite' has not been quantified, leaving it an open target for management to determine dynamically and opportunistically. The discretion to impose a risk appetite on the firm at a level and at a time preferred by management represents a manifestation of power also generated in the dispositional circuit. In effect the ability to change the risk appetite of the firm is like changing the rules relating to risk management. Barring unforeseen events, an elevation of risk normally translates to an increase in returns. Therefore by socially integrating the rules relating to risk amongst staff, management was empowered to elevate the returns of the firm. This power is transmitted via a passage point represented by risk limits within which traders and deal makers are required to maintain risk exposures. The power is subsequently exercised in the episodic circuit where the routine transactions that reflect the revised risk levels are executed.

Figure 159 also encourages Fuld's vision of the firm's culture by stating the goal to "continue to strengthen the culture" and instil this strong cultural push to the entire team with phrases such as 'one team' and 'one firm mindset'. The incentive to collaborate with this push for a singular culture is neatly linked to the objective of applying "significant equity compensation – 30% employee ownership...All employees acting like owners" (Lehman Brothers Holdings 2006, p. 31). As clearly outlined in the slide, senior management are also considered substantial owners of the firm, and therefore participate on both sides of the agency relationship spectrum, which presents opportunities for conflicts of interest.

Figure 159 - Summary of Strategy – March 2006.



Source: (Lehman Brothers Holdings 2006, p. 31).

The messages and meanings directed to the audience of senior executives by the Global Strategy document is clarified through the analysis of rhetoric contained therein. The above analysis elucidates Fuld's mission of achieving outperformance to its peer group, with a benign attitude to risk, supported by conformity to a unified 'aggressive culture'. As discussed above, Fuld made use of power often generated in the dispositional circuit and exercised in the episodic circuit to achieve these ends. Further evidence of the firm's culture can be gauged by communication modes such as internal and external conversations and emails. The following section examines some examples of these modes of communication to further illustrate the culture Fuld attempted to engender.

10.6.2 Internal Emails as a Window to Firm Culture

As mentioned throughout section 10.6, the power Fuld possessed in influencing the culture within the firm is established through various types of communication. Adhering to the analysis of rhetoric used in the Global Strategy document in section 10.6.1, the following analysis elaborates on this theme with the use of internal emails as a form of communica-

tion. The analysis will use metaphors and analogies to extract meanings in senior management's attempts to "persuade others about the correctness of [a] particular view of reality" (Young 2003, p. 623). The reality being constructed continues to consist of a view of the firm as an unfailing organisation that will survive at all cost using whatever means necessary. The analysis reveals the hubris relating to both management's abilities and their flawed view of the economic circumstances that prevailed until the final days of LB.

Fishman (2008, p. 4) describes Fuld's siege mentality and instincts by quoting excerpts from some of his conversations:

Sometimes, that instinct meant that Lehman would 'decide that we should be doing the exact opposite of what the analysis said', as one analyst put it. At the top of the organization, Fuld instilled his pugilistic, paranoid view of the world: It's us against them. 'Every day is a battle', he told his managing directors. 'You've got to kill the enemy. They tried to kill us'. Lehman, as he saw it, was always in danger, never getting respect even as it became the country's fourth largest investment bank. 'We're going to keep showing people not to underestimate us', he said. And the troops, as Fuld called them, bought in.

As shown above, Fuld's communication style was at times direct and poignant. Phrases such as 'You've got to kill the enemy', exhibit a raw and emotional attitude towards business and a mentality of winning at all costs. This attitude, coming from the top, likely permeated throughout the organisation, engendering a highly competitive and aggressive spirit with the firm. Internal emails of LB can offer a view on the culture operating within the firm. The Committee on Oversight and Government Reform, 2010 set out excerpts of certain key LB internal emails in their report. An analysis of these emails is set out below.

two steps are necessary. First we must identify what went wrong, then we must enact real reforms for our financial markets.

Over the next 3 weeks, we will start this process in this committee. We will be holding a series of five hearings on the financial meltdown on Wall Street. We'll examine how the system broke down, what could have been done to prevent it, and what lessons we need to learn so this won't happen again.

Today's hearing examines the collapse of Lehman Brothers, which, on September 15th, filed for bankruptcy, the largest bankruptcy filing in American history. Before the Lehman Brothers bankruptcy, Treasury Secretary Paulson and Federal Reserve Chairman Bernanke told us our financial system could handle the collapse of Lehman. It now appears they were wrong. The repercussions of this collapse have reverberated across our economy. Many experts think Lehman's fall triggered the credit freeze that is choking our economy, and that made the \$700 billion rescue necessary.

Lehman's collapse caused a big money market fund to break the buck, which caused investors to flee to Treasury bills and dried up a key source of short-term commercial paper. It also spread fear throughout the credit markets, driving up the costs of borrowing.

Over the weekend we received the testimony, the written testimony, of Richard Fuld, the CEO of Lehman Brothers. Mr. Fuld takes no responsibility for the collapse of Lehman. Instead he cites a, "litany of destabilizing factors," and says, "in the end, despite all our effort, we were overwhelmed."

In preparation for today's hearing, the committee received thousands of pages of internal documents from Lehman Brothers. Like Mr. Fuld's testimony, these documents portray a company in which there was no accountability for failure. In one e-mail exchange from early June, some executives from Lehman's money management subsidiary Neuberger Berman made this recommendation: Top management should forego bonuses this year. This would serve a dual purpose. First, it would represent a significant expense reduction; second, it would send a strong message to both employees and investors that management is not shirking accountability for recent performance.

The e-mail was sent to Lehman's executive committee. One of its members is George H. Walker, President Bush's cousin, who is responsible for overseeing Neuberger Berman. And here is what he wrote the executive committee. "Sorry, team. I'm not sure what is in the water at 605 Third Avenue today. I'm embarrassed, and I apologize."

Mr. Fuld also mocked the Neuberger suggestion that top management should accept responsibility by giving up their bonuses. His response was, "don't worry, they are only people who think about their own pockets."

Another remarkable document is a request submitted to the compensation committee of the board on September 11th, 4 days before Lehman filed for bankruptcy. It recommends that the board give three departing executives over \$20 million in, "special payments." In other words, even as Mr. Fuld was pleading with Secretary Paulson for a full rescue, Lehman continued to squander millions on executive compensation.

The above commentary on LB's emails, clearly demonstrate Fuld's disdain of a plan to forgo bonuses by 'top management' (including himself) and his natural inclination to distrust those Neuberger Berman executives who would suggest such a tactic. The objective of the Neuberger Berman executives was to generate savings for the firm and send a clear message to investors of the intended conservative stewardship of the firm. Further, Fuld's audacity of recommending extra compensation to some top management four days before LB filed for bankruptcy clearly demonstrates the greed and self-interested attitudes pervading the senior ranks of the hierarchy. Alternatively, Fuld could have been attempting to signal to the market LB's confidence in a turnaround by increasing its compensation expenses. Both of the above incidents reported by the Committee on Oversight and Government Reform provide a window into the 'greed-centric' culture Fuld was supporting. This culture is further exemplified by a series of other LB internal emails sourced by the bankruptcy examiner. An analysis of these emails follows.

10.6.3 Emails Regarding Escalating Risks

A March 2007 email forwarded by Michael Gelband, LB's Head of Capital Markets to Fuld refers to advice provided by respected investment managers, Stanley F. Druckenmiller of Duquesne Capital Management LLC and Paul Tudor Jones of Tudor Investment Corp confirming Gelband's previously mentioned concerns regarding the risks of the firm and that consideration should be given to the balance of risk versus return:

This is not the B-team, Gelband wrote. I heard your view at the risk meeting that odds are in your favour but risk/reward is not good here so I'm trying to get out of as much illiquid risk as possible (Valukas 2010, p. 46).

Further examples of emails from risk managers to senior management warning of the inappropriateness of the firm's risk limits and risk policies, are presented below:

Email from Kentaro Umezaki, Lehman, to Herbert H. (Bart) McDade III, Lehman, et al. (Sept. 10, 2008) (noting history of end arounds on risk decisions, risk management's lack of authority and lack of authority over balance sheet and inability to enforce risk limits); Email from Vincent DiMassimo, Lehman, to Christopher M. O'Meara, Lehman (Sept. 1, 2008) (whatever risk governance process we had in place was ultimately not effective in protecting the firm. Risk Appetite measures were not effective in establishing clear enough warning signals that the Firm was taking on too much risk relative to capital. The [Risk Management] function lacked sufficient authority within the Firm. Decision-making was dominated by the business); Email from Satu Parikh, Lehman, to Michael Gelband, Lehman, Sept. 15, 2008 (I am shocked at the poor risk management at the highest levels, and I don't think it started with Archstone. It is all unbelievable and I think there needs to be an investigation into the broader issue of malfeasance. Management gambled recklessly with thousands of jobs and shareholder wealth) (Valukas 2010, p. 46).

An email dated 18 April, 2007 to O'Meara amongst others from Kentaro Umezaki, Head of Fixed Income Strategy for LB confirmed the confusion of the Fixed Income Division following a verbal presentation by Fuld the night before. In his presentation, Fuld urged an increase in risk. In describing his team's reaction to Fuld's speech, Umezaki wrote:

...the majority of the trading businesses focus is on revenues, with balance sheet, risk limit, capital or cost implications being a secondary concern. The fact that they [the traders] haven't heard that those items matter [in] public forums from senior management recently reinforces this revenue oriented behaviour implicitly... Example which we've debated for years: was even a topic in [the Turnberry meeting in] FLA: Do we or don't we have a limit on how much HY LBO related lending/commitment exposure we can have at any given time? There has been no real 'one firm' outcome to date in my opinion. I'm not the only one who has this view in FID (Valukas 2010, p. 100).

The above email confirms three important points: firstly that consideration of risks was secondary to the priority given for the generation of revenues; secondly, senior management had avoided communicating the 'revenue over risk' priority to the financial markets; and thirdly there was no clear communication of risk limits relating to high yield leverage buy-outs⁹² (HY LBO) to staff in the trading department. The ambiguity over the communication to both external and internal stakeholders created an environment which encouraged the treatment of risk limits as a 'soft' constraint and capable of being easily adjusted. The underlying message conveyed was that an increase in risk levels was plausible. Fuld's obvious intention was to perpetuate an elevated 'risk culture' of the firm as a means of increasing its returns.

The creation of the abovementioned ambiguity regarding risk limits is an expression of power emanating from what is 'not communicated' and found in the dispositional circuit. Risk limits are a common feature used in investment and commercial banks. They constitute restrictions on traders' behaviours, limiting their ability to exceed the firm's pre-determined risk appetite. However in LB's case these limits were unclear, which is extraordinary for a firm whose major portion of revenue was generated from the Trading Division. Therefore

⁹² High yield leverage buyouts are transactions involving the purchase of high yielding risky bonds usually rated sub-investment grade. Although these bonds attract high returns, they are often referred to as 'junk bonds' given their probability of default is relatively high.

traders were required to interpret their own acceptable risk limits through their establishment of a socially constructed meaning created from their communication with senior management. As no communication was evident or at best ambiguous, traders were left to establish their own rules. Fuld's power in this circumstance was exercised in his decision to remain silent on the topic of risk limits. In doing so, he enabled traders to trade up to their own discretionally imposed limits. The temptation naturally would be for a trader to incur as much risk as possible under these circumstances, as higher risk limits translated to more or riskier trades thereby increasing the potential for greater bonuses. Fuld understood this driver, being a former trader, and created the setting for this behaviour through his silence on the matter which in itself represented the passage point where power was transmitted to the episodic circuit.

In expressing the power exerted by Japanese management as a cultural practice Clegg and Bailey (2007, p. 732) observed the influence on a team of management silence:

...management owes very little to formal rules. Rather the power to guide practice... is mediated-informally-by close knit relationships by insiders who come to know each other well. The slightest nuance of body language or the significance of what is not said can convey important information to a fellow insider.

The trades executed by the traders within their own 'set of rules' were carried out in their routine activities, which they considered normal and acceptable within the risk management framework of the firm.

10.6.4 Emails Regarding Raising Extra Capital

During the second half of 2007, as certain assets such as CDOs held by many investment banks were devaluing, there was a search for additional capital to counter the associated losses and increased risk levels. Three similarly financially distressed financial institutions including Citigroup, Bear Stearns and LB, had approached the Citic Group, a leading Chinese investment bank in their quest to seek a strategic stockholder for their corporations in order to provide the much needed capital (Valukas 2010).

Although a potential investor the size of Citic Group presented as an ideal 'White Knight', given their access to capital, an email exchange between Fuld and Goldfarb revealed little interest in Citic Group and a degree of arrogance and hubris. The following initial email from Goldfarb to Fuld signalled a view that LB did not need assistance:

This will signal a major sign (which obviously isn't true and will feed into rumours, etc.) and put us in a category of those who needed an infusion to help them out of this market mess. (Goldfarb 2007).

Fuld's response reveals crudeness in the use of language such as 'NFI' (abbreviation for 'no fucking idea'):

Sounds to me like another non-starter. If it's just about price [and] who is the right partner then tell them NFI (Fuld 2007).

Goldfarb replied:

Agreed 1000 percent ... How do you spell stupidity in Chinese!!! (Goldfarb 2007).

The above email exchange exemplifies a degree of arrogance and misguided faith that the firm didn't need assistance in the form of a White Knight. Young (2003, p. 624) acknowledges that text such as the above email exchange can be the result of calculated thoughts by managers who purport to have a superior understanding of a situation. The absoluteness of the expression used to signify full confidence: '1000 percent' indicated that Fuld and Goldfarb knew what they were doing, even though the search for a 'White Knight' had become an urgent matter. The exchange continued displaying a high degree of macho condescension with an email by Fuld indicating a trace of racism:

What happened, ... u didn't like my sumdum spelling? (Fuld 2007).

Goldfarb responded in an arrogant vernacular:

I love it, better said than I could have. I think Mizuho is the best option for strategic partner. Any potential investor that would consider BS Bear Stearns in the same breath as LB should go fungoo themselves!!! (Goldfarb 2007).

Fuld replied, again with a degree of unprofessional overconfidence, this time expressed in a hood⁹³ like expression with a indolent use of grammar:

I agree we need some help but the Bros always wins!! (Fuld 2007).

Goldfarb agreed, responding with the following:

Absolutely, will and skill always win, and that be us!!!! (Goldfarb 2007).

Fuld concluded:

⁹³ Hood is a colloquial term describing someone who acts like they are from the ghetto.

Got it so do u (Fuld 2007).

The style of communication reveals two of the most senior executives in the firm as self-congratulatory, arrogant and misguided. It also exposes the executives' lack of seriousness and urgency in confronting the problems of the firm. The rhetoric used reveals a similarity in the crude and assertive culture that existed at LB. The texts also exhibit a common understanding amongst two of the most senior executives at LB, who use a similar vernacular tending to confirm each-others' beliefs that LB can afford to be selective in selecting a 'White Knight'. The reciprocal encouragement to pursue a course of action reinforces a confidence in their conviction. Young (2003, p. 624) notes the power of texts to modify or reinforce convictions:

Texts perform actions as they encourage certain beliefs and behaviours. The various arguments within texts are intended to modify the convictions or disposition of specific audiences through persuasive discourse rather than through an overt imposition of will or through constraint.

Had Fuld and Goldfarb not persuaded each other to dismiss the alternative 'White Knights', the path to bankruptcy could have been avoided. In January 2008 when LB perceived an opportunity to again raise capital, this time from the Kuwait Investment Authority, Goldfarb, CFO, wrote to Fuld:

Only issue would be that if they bought newly issued equity we would join the bad company of the many who had to raise equity. Perception issue (Goldfarb 2008).

As mentioned in section 6.3, at a time when a capital-raising was desperately needed by LB, and there was a dearth of institutions willing to invest, Fuld exhibited a degree of hubris by suggesting charging the Kuwait Investment Authority a premium for LB's stock and responded to Goldfarb as follows:

Not if it were at a premium (Fuld 2008).

Consequently the intended capital raising failed. This is not surprising given the probable unwillingness of the potential investor to pay a premium in such a tight capital market. Fuld's hubris prevented a much needed capital-raising as confirmed by Paulson's opinion that Fuld's perceptions of the firm's problems were unrealistic - discussed in section 6.6.2. Fuld and Goldfarb believed LB would survive, by advising the Board in January 2008 that:

During the last downturn [2001-02]... the firm outperformed its competitors and established a platform for further growth... The firm pursued a counter-cyclical strategy, investing in talent while its competitors were in retrenchment mode (Lehman Brothers Holdings 2008a, pp. 6-7).

The above statement indicated that LB could repeat the turnaround strategy in 2008 that it employed during the economic downturn of 2001/2002. At the Board meeting in January, 2008, Fuld was able to influence the Board in agreeing to pursue growth as a counter-cyclical strategy which was contrary to the strategy employed by the rest of the major US investment banks. Other investment banks pursued a strategy which involved raising capital in anticipation of future losses. Fuld justified his growth strategy by explaining that:

... while other Wall Street firms were raising significant capital in the past three months, for Lehman aggressive capital raising is not necessary because the firm remains strongly capitalized thanks to capital generated by earnings (Lehman Brothers Holdings 2008a, p. 16).

The retained earnings on which Fuld relied for extra capital were never realised. In fact a massive loss was about to be recorded in the ensuing quarter ending May 2008 (Lehman Brothers Holdings 2008c). Fuld's refusal to follow the other investment banks which undertook capital raisings in anticipation of losses further signifies Fuld's conviction that he knew better. The other investment banks imitated each other as a survival tactic intended to also comfort their investors and creditors. The common view of impending danger was not shared by Fuld who was blinded by hubris and a disregard of his own firm's stockholders to whom he owed a responsibility under agency principles.

LB's cultural problems indicated by its internal communications were compounded by a question over its ethical practices. Despite the external appearance of an ethical best practice, the following section discusses certain shortcomings. It is argued that the questionable ethical practices emanated from the abovementioned cultural atmosphere.

10.7 Code of Ethics – Was it practiced at LB?

LB disclosed in its 2007 Form 10-K report submitted to the SEC that it possessed a Code of Ethics with which it complied. The report specifically mentions that:

'We [LB] recognize that maintaining our reputation among clients, investors, regulators and the general public is critical. Maintaining our reputation depends on a large number of factors, including the selection of our clients and the conduct of our business activities. We seek to maintain our reputation by screening potential clients and by conducting our business activities in accordance with high ethical standards' (Lehman Brothers Holdings 2007, p. 76).

Further the report states that LB acknowledges its 'other' risks as follows:

We are exposed to other risks having an ability to adversely impact our business. Such risks include legal, geopolitical, tax and regulatory risks that may come to bear due to changes in local laws, regulations, accounting standards or tax statutes. To assist in the mitigation of

such risks, we monitor and review regulatory, statutory or legal proposals that could impact our businesses (Lehman Brothers Holdings 2007, p. 76).

As argued in section 10.3, despite maintaining a formally documented modern day corporate governance policy, an organisation may not actually adopt best practice. Lehman Brothers Holdings (2007, p. 76) described LB's ethical standards as 'high'. However, this thesis argues that LB's ethical standards were far from high. Examples cited in this chapter which indicate an ethical standard less than optimal include: the firm's 'window dressing' of financial statements, (refer CHAPTER 9 for a discussion of this practice); the treatment of employees and their families; and the firm's internal emails discussing potential investors. It is expected that a firm's ethical practices would have an impact on the culture within an organisation. Yet LB managed to contravene some key ethical considerations.

Greenfield (2009) asserts that LB's aggressive culture allowed it to avert a financial disaster during past economic downturns such as in 2001/2002. Most of the incumbent management team in 2008, occupied senior management positions during 2001/2002, including Fuld who occupied the CEO and Chairman positions. The same aggressive culture said to exist in 2001/2002 also existed up to 2008. Management's aggressive culture supported by Fuld's hubris described above, blinded senior management from the risks posed by the firm's excessive leverage which was incurred during the pre-GFC period.

As described in section 10.4.2, Fuld ignored critical advice from expert staff in some key decision-making. Apart from ignoring expert advice, LB's dysfunctional management style disregarded the firm's code of ethics. "The code of ethics became an artefact; something external to the culture and existed because companies like LB needed a code for public relations purposes and to protect themselves from conduct against the firm" (Stevens 2008, p. 53).

A legalistic approach to the adoption of a code of ethics by US firms was found to be a common finding by (Pelfrey & Peacock 1991, p. 17). Farrell and Cobbin (1996) analysed the content of codes adopted by Australian, US and UK enterprises and found that for many organisations, the codes were a "reiteration of the legal obligations of staff" (Farrell & Cobbin 1996, p. 55). This indicates a perfunctory approach to the adoption of a code of ethics as opposed to an independent and holistic approach with a purpose to instil appropriate values. Further, Farrell and Cobbin (1996, p. 55) found that 83 per cent of the codes of ethics examined addressed the behaviours of employees and ignored standards for directors. This study also concluded that the codes examined did not directly promote the adoption or support ethical cultures. It is not surprising therefore that LB treated its code of ethics as a necessary document to fulfil the expectations of regulators and investors rather than to provide an ethical influence over the culture of the firm.

Stevens and Buechler (2013) used two different methodologies to ascertain whether LB's code was instrumental in management decision-making. They used the 'Competing Values Framework'⁹⁴ developed by Quinn et al. (1991) in conjunction with the 'Ethisphere benchmark'⁹⁵ created by Erwin (2011). They argue that LB's code was similar to codes found in similar documents of other US public corporations. The code "addresses the basic issues found in most corporate codes such as conflict of interest, retaliation, stealing and use of proprietary information, non-retaliation, compliance with laws, EEO issues and fairness" (Stevens & Buechler 2013, p. 51). According to Stevens and Buechler (2013), LB's code appeared standardised and authored by lawyers as opposed to being specifically prepared for LB.

Although appearing as a standardised document, the code of ethics provided a clue to LB's aggressive culture. LB's relentless pursuit of growth is reflected in a phrase used in its code of ethics: "to compete aggressively in furthering the interests of the firm" (Stevens & Buechler 2013, p. 51). The choice of the word 'aggressively', in this section of the code of ethics clearly establishes a guiding principle that aggressive behaviour in furthering the interests of the firm was acceptable. Similar references alluding to an 'aggressive pursuit of business' are also found in the documented code of ethics of another failed US investment bank, Bear Stearns (Greenfield 2009). However Greenfield (2009, p. 53) observes that it is "absent from one of the two surviving firms' codes - Goldman Sachs' Code of Conduct and Business Principles". Stevens and Buechler (2013) state that although LB's code dictates that the firm should 'compete aggressively', it neglects to mention how an employee can compete aggressively in an ethical context and fails to articulate the boundaries of such aggressive behaviour. Therefore how could an employee clearly ascertain the boundaries of their expected ethical behaviour in pursuing their day to day activities?

Evidence suggesting unethical practices by LB is contained in a letter dated 18 May 2008, authored by Matthew Lee, then senior Vice President, Financial Control and in charge of the firm's global balance sheet and accounting, addressed to Erin Callan CFO, and Christopher

⁹⁴ The Competing Values Framework is a grading framework which analyses exchanges of discourse by revealing the use of rhetoric in communication.

⁹⁵ The Ethisphere benchmark assigns grades on a code of ethics based on eight ideal dimensions of a code established by the Ethisphere Institute.

O'Meara Chief Risk Officer at LB. The letter stated that Lee had become aware of unethical practices at LB:

I have become aware of certain practices....that require me as a Firm employee to bring to the attention of management conduct and actions on the part of the Firm that I consider to possibly constitute unethical and unlawful conduct (Lee 2008, p. 1).

Lee's complaint targeted a misstatement of assets published in the previous quarters' financial statements leading up to May 2008. In his opinion the value of assets published in the financial statements misled the public as they had been devalued due to market corrections. "I believe the manner in which the firm is reporting [certain] assets is potentially misleading to the public and various governmental agencies" (Lee 2008, p. 2). He claimed that a significant level of assets may have been overstated as they should be classified as either 'non-performing' or 'bad'. The quantum of the overstatement was considered significant: "Tens of billions of dollars of unsubstantiated balances, which may or may not be 'bad' or non-performing assets" (Lee 2008, p. 1). This criticism by an employee of 14 years was ignored by senior management who retrenched Lee a few days after the date of his letter (Corkery 2010).

This section argues that the culture of LB largely emanated from the values and beliefs of the leadership team and not a published code of ethics reflecting best practice. The values of the CEO and other senior executives were embedded in the firm. The code of ethics, like the corporate governance structure, as discussed in section 10.2, was a mere construct. Fuld relegated the practice of the published code of ethics, through his refixing of the meanings of appropriate behaviour, as Clegg (1989) explained, by fixing relations of meanings in the dispositional circuit. The divergence of meanings from the published code to Fuld's socially constructed code was carried out through his various forms of communication, which, as passage points, transmitted power to the episodic circuit where the associated behaviours were expressed in daily work routines as explained in section 10.6. And in the process he restricted the effect and influence of the code of ethics effectively 'disempowering' the document and its meaning.

10.8 Summary

This chapter examined the management style of Fuld and his senior executive team and its impact on the important management decisions which led to LB's bankruptcy. The management style is found to contribute to the 'greed centric' culture of the organisation which was encouraged by institutional influences and the exertion of power by Fuld. These influences which were nurtured within an overall less than perfect corporate governance prac-

tice were manifest in Fuld's relationship with the Board of Directors and the institutional forces which shaped board structure; Fuld's influence over employee behaviour; the various forms of communication used by Fuld and his senior executives; an ethical practice at odds with the firm's formal code of ethics; and an employee compensation structure which encouraged risky behaviour and a general compliance with Fuld's values and beliefs.

Fuld is shown to have had an influential role in the appointment of a submissive and compliant Board. Structuring the Board with members whose ages,, longevity of tenure, limited financial expertise in financial markets and above average compensation, contributed to a relative disengagement in the risk affairs of the firm and created a subservient attitude towards Fuld's strategic intentions. In addition, the mimetic and normative institutional influences to which LB was subjected concealed a corporate governance framework, including board structure, which, although complied with the regulatory framework, did not engender professional and ethical practice.

Fuld was able to engender loyalty from his staff, principally by ensuring they were remunerated at the top end of the industry's pay scale, including a generous incentive compensation plan. This loyalty produced mostly compliant subordinates who largely adopted Fuld's strategy of 'growth at all costs'. Fuld's behavioural traits can be traced to his earlier career where he learned the value of loyalty and the dangers associated with strong personalities with potential to challenge the authority that comes with leadership. Those who challenged Fuld's values or views, especially in relation to the firm's direction and its associated risks, were punished. The resultant culture empowered Fuld to pursue his growth objective with the aim of perpetuating generous bonuses for his key staff and himself.

The chapter also provided an insight to the firm's culture aided by a rhetorical analysis of the manner and style of communication adopted by Fuld and his close associates. It is shown to offer a deeper understanding of how communication devices and the use of language and discourse can impact meaning to foster certain behaviours and influence values consistent with those of the author. The resultant culture was coloured by a hubris associated with a denial of LB's escalating risk profile and the worsening financial difficulties.

Finally, the chapter questions the firm's ethical values as exposed by its application of the firm's publicly stated code of ethics, which although presented as an example of best practice, was found to be somewhat ignored at the firm. The treatment of employees and their families, the style and content of the firm's communications, and the attitudes expressed in communications towards creditors and potential investors attest to the firm's relative disregard of ethical practice. This disregard is also reflected in LB's unethical accounting of repurchase agreements used as a temporary financing tool in an effort overcome the firm's reliance on excessive debt.

CHAPTER 11 CONCLUSION

This chapter summarises the thesis and presents the findings in response to the research question posed in section 1.1. It also presents the contribution of the research and its relevance to current investment banking and regulatory practice. Finally the chapter outlines the limitations of the thesis and offers recommendations for future research.

11.1 Thesis Summary

This research provides a rich insight into the culture and behavioural practices of LB and the participants in the investment banking industry. This issue is important as culture and behavioural practices have been found to influence management decision-making crucial to the viability of businesses in the lead up to the GFC. Furthermore, it demands attention from legislators and regulators who routinely deal with individual firm and systemic risk which could impact the wider economy. This thesis shows an example where legislators and regulators have failed to manage these qualitative factors amongst other prudential supervisory responsibilities and therefore have failed to protect the public interest. It is therefore of particular relevance in the current environment where an increasingly lenient regulatory setting is being discussed in the US. As regulatory strictures and economic policies continue to be subjected to various influences and swing from loose to tight settings, this thesis will continue to have relevance. Additionally as unchecked concentration of power and deficient corporate governance systems continue to exist in large organisations the danger of other catastrophic bankruptcies will persist.

The thesis is organised by initially presenting a background to the economic, regulatory and political environment over the time period up to the GFC. The review and discussion of the theoretical framework of DiMaggio & Powell's (1983) New Institutional Theory, augmented by Clegg's (1989) Theory of Power, is presented in CHAPTER 3. This chapter links the theoretical framework to a critical analysis methodology involving a case study approach using LB as its subject. The case study approach emphasises the importance of acknowledging the social, political and economic contexts within which the investment banking industry can be analysed to explain the various influences acting upon it and its use of influence in generating beneficial outcomes.

Two historical chapters follow which offer an understanding of the evolving culture and practices of the investment banking industry. CHAPTER 4 presents an historical overview of the US investment banking industry, highlighting the roles and behaviours of a sample of personalities who were influential in shaping the culture found in modern day investment banking. Certain historical events such as economic crises and the pressures on investment banks to modify their business models are also discussed in this chapter. CHAPTER 5 follows with a history of LB, which tracks the development of the firm's culture through an account of the key individuals within the firm from its founding by the three Lehman brothers in 1850 until the firm's demise in 2008 whilst it was headed by its CEO, Richard Fuld. The chapter is divided between periods covering the pre-Fuld era and the post-Fuld era, in order to compare and contrast the specific cultural traits impacting the firm between these two periods which shows the post-Fuld era as one characterised by dysfunctional senior management decision-making.

The last days of LB warranted a dedicated discussion in CHAPTER 6 given the important decisions made by senior management which directly led to the firm's downfall. An explanation of some of the important innovations and practices of the industry, such as the development of large scale securitisation warehouses, complex derivative products such as CDOs and MBS, and the outsourcing of origination activities to commission driven agents, combined with the lack of transparency exhibited by LB, sheds light on some of the immediate causes of the GFC. The business models and financial structures of the major investment banks are discussed in CHAPTER 7. They were found to be similar and influenced by an institutional isomorphism, therefore subjecting them to the same consequences from severe economic and financial market shocks. Further, this chapter discussed the profitability benefits of the leverage effect which were well understood and exploited by the investment banks.

The value of connections developed by the investment banking community within the 'financial network' consisting of the investment banking industry; other financial institutions; the regulators; the government; CRAs; and, lobby groups representing the investment banking industry is analysed in CHAPTER 8. The influence over accounting standard setters was exemplified by the generation of an ambiguous accounting standard covering Repo 105 transactions - FAS 140. CHAPTER 9 further explains Repo 105 in detail and analyses the power exerted by LB's senior management in ensuring the manipulative use of accounting for this financial instrument achieved the desired effect of concealing significant levels of debt.

CHAPTER 10 concludes with an analysis of Fuld's management style and the firm culture. The chapter suggests that Fuld was driven by self-interest. His exercise of power involved an influence over the firm's corporate governance, employees, their families and the firm's accounting process. This power is shown to be generated and exercised in Clegg's (1989) facili-

tative, dispositional and episodic circuits of power, resulting in a culture which prioritised the objective of 'growth at all costs'. The consequential culture is highlighted by an examination of a sample of communications between senior executives of the firm and between internal executives and outsiders. Finally, an assessment of the firm's documented commitment to ethical values is shown to be divergent from the firm's actual practice. The following section outlines the findings of this study in more detail.

11.2 Findings from the Study

This thesis addresses the following research question:

To what extent did the cultural and behavioural influences through the context of an institutional framework and interplays of power within the investment banking industry contribute to the failure of LB?

This analysis reveals the historical and cultural factors relevant in answering how and why LB failed. Three recurring themes were revealed in the historical chapters. The first recurring theme deals with the empowerment of investment bankers through their knowledge, expertise and innovation. The second recurring theme involves the value of close relationships which enabled investment banks to grow their business and solve complex problems for their customers. Thirdly, the chapters reveal the effect of externalities, such as economic cycles, and political/regulatory developments on the fluctuations of power between regulators and industry. These themes contributed to certain behaviours and organisational culture found in modern day investment banking. The benefit of highlighting these themes is to draw a comparison between them to those factors which impacted on LB. It was found that LB senior management, in particular its CEO had coveted power to satisfy motives of self-interest, which when combined with institutional influences from a variety of external agencies, influenced a dysfunctional organisational culture which led to the collapse of the firm.

The case study approach focusing on LB is set within an historical context and offers an insight into the US investment banking industry prior to 2008. The case study provided an analysis of practice within the industry and permitted an evaluation of the two theoretical frameworks. The theories were applied over the evolution of the US banking industry since its beginnings - a period of over 230 years. They were found useful in explaining the cultural and behavioural influences on the investment banking industry which contributed to the failure of LB.

The selection of LB as a representative of the US investment banking industry is considered appropriate given the peer group's largely similar business models and financial structures. Moreover, most of the peer group suffered a similar fate either requiring a government

sponsored rescue, or merger with a stronger financial institution. LB however was the only member which entered official bankruptcy and was effectively allowed to fail by the authorities. This unique position allows for a deeper insight into the motivations of various stakeholders including authorities and provides a window into the world of investment banking in the pre-GFC period. The critical analysis is conducted using two theoretical frameworks. Clegg's (1989) Theory of Power is used to augment DiMaggio & Powell's (1983) New Institutional Theory to explain the abovementioned dynamic influences. This chapter presents the findings over three sections: Section 11.2.1 explains the development of the investment banking culture from an historical context; section 11.2.2 presents the various institutional influences on the investment banking industry and in turn its influence on other organisations; and section 11.2.3 finds that the use of power within LB was instrumental in shaping the key decision-making which led to the deterioration of LB's financial performance. Each section supports the conclusion that the use of institutional influence and power was an important contribution to the downfall of LB.

11.2.1 Development of the Investment Banking Culture

The historical context in which this story is told is important as it offers an understanding of the origins of the behaviours and culture found in modern day investment banks. The historical chapters comprising CHAPTER 4 and CHAPTER 5 reveal the organisational evolution of LB in parallel to the development of the investment banking industry which had its foundations in the American War of Independence of 1775. The latter period covered by this study is characterised by a period governed by a neo-liberal political environment, a burgeoning economy and a 'light touch' to investment banking regulation. The three overarching themes developed in the historical chapters are discussed below.

Traditionally, investment bankers have been able to add value in arranging funding for customers or providing advisory services. These activities could be sustained as long as they offered specialised knowledge, expertise and innovation which otherwise was largely unavailable within industry generally. The attributes of knowledge, expertise and innovation commonly found amongst all members of the peer group supports the argument that various institutional influences contributed to the culture, practices and behaviours found throughout the investment banking industry. The effective use of novel funding techniques such as the first bond issues, the adoption of effective distribution networks in selling financial instruments, the development of risk transfer instruments such as credit derivatives, and the methods of assessing credit risk of borrowers were able to set participants apart within the industry. The application of the two theories mentioned above is useful in explaining how knowhow emerged as a force in investment banking and why it was keenly sought to gain financial advantage. Clegg's (1989) facilitative circuit is where power is generated by techniques of production which is translated as the knowhow of arranging difficult financings. Once observed within the field, DiMaggio & Powell's (1983) normative and

mimetic pressures, allowed the abovementioned innovative practices to survive until the modern era as they were accepted as a safe and legitimate practice by which to operate and succeed. By excelling in these practices, firms and individuals within the industry could develop a competitive advantage.

The thesis used the influential roles played by key individuals such as Haym Salomon, Robert Morris, Albert Gallatin, David Parish, John Jacob Astor, Stephen Girard, Nicholas Biddle, Clarke Dodge, James Gore King, Anthony Joseph Drexel, and the well-known John Pierpont Morgan to show that power sourced from the application of knowledge, expertise and innovation enabled beneficial outcomes. These selected individuals are highlighted since they represent a sample of prominent US investment bankers operating during the formative years of the industry. They were therefore the early leaders who were able to shape the culture and practices within the industry.

Since the industry's inception, investment bankers have realised the importance of business and government relationships for the development of their enterprise. The thesis finds the strategy of pursuing relationships with important individuals within larger organisations and especially government was mimicked for three reasons. Firstly, it was hoped such clients would provide a continued stream of large and lucrative transactions. Secondly, given the high social and commercial status of the individuals involved, these relationships would help with the firm's image and reputation, and expand the networks useful for potential future business. Lastly, networks were also useful as an instrument in pushing a point of view with government and regulators. The exploitation of relationships also worked in reverse whereby government officials used investment bankers to meet their needs, for example, Albert Gallatin, US Secretary of Treasury who used Stephen Girard, John Jacob Astor and David Parish to assist with the financing of the War of 1812.

The thesis finds that externalities such as economic cycles, and political/regulatory developments had an effect on the fluctuations of power between regulators and industry throughout the history of the US investment banking industry. Attitudes towards regulatory strictures tended to vary according to economic conditions. Following a financial crisis for example, public outcry would prompt politicians who, sensitive to public opinion, were prone to tighten financial markets regulation or censure influential personalities within industry. Examples of these trends include: the panic of 1907 which was followed by the Pujo Commission and which brought into scrutiny JP Morgan's business activities; and the Great Depression which was followed by the Percora hearings and prompted a swathe of regulations between 1933 and 1940. Conversely, the 'light touch' approach to regulation coincided with prosperous economic conditions such as those which prevailed prior to the 1929 stock market collapse and the period prior to the GFC. The hubris which is generated by a period of economic expansion tended to lure legislators into a 'laissez faire' mentality.

In summary, the historical chapters find that during prosperous periods of economic expansion, there is a danger that politicians and regulators are prone to adopt a 'laissez faire' approach and succumb to institutional pressure to apply a 'light touch' to regulation. Concurrently, there is a potential risk that policy setters prolong accommodative monetary conditions which tend to stimulate financial markets, at times creating asset bubbles which often precede a financial crisis.

11.2.2 Application of Institutional Influence

A finding of this thesis is that institutions including the members of the 'financial network' are subject to and/or conveyors of DiMaggio & Powell's (1983) various forms of institutional influence. This exertion of influence, if unchecked can contribute to dire consequences such as the GFC. Specifically, the thesis finds institutional influence was meaningfully applied in four areas: the business models and financial structures of the major US investment banks; the legislative process and regulatory framework; the CRAs and the accounting standard setting process.

When business models of major participants in the investment banking industry converge and their financial structures similarly take advantage of loose regulatory settings such as the inadequate Net Capital Rule which existed prior to the GFC, the resultant systemic risk adds to the probability of industry failure.

The business model of investment banks up until the immediate post WW2 period largely comprised the partnership business structure, with its disadvantage of a partner's restricted capacity to contribute capital to the firm. Due to the increasing need for capital to sustain business expansion, firms sought to incorporate. Unlike a partnership, this structure with its limited liability protection meant that CEOs could take abnormal risks with the expectation of generating abnormal profits without placing themselves at personal financial risk, as would a partner in a firm. As executive compensation structures were aligned with performance generally, executives were incentivised to push the boundaries of acceptable organisational risk levels. CEOs at the helm of the firm could also monopolise potential bonus pools in contrast to the typical profit sharing model of a partnership. These factors led to the concentration of power to the CEO and allowed for an elevation in the firms risk profile.

Further as investment banks operate in a competitive and ambiguous environment, where economic cycles, evolving technology and innovation are constant features and challenges, mimetic pressure led divisional units of the peer group to undertake similar lines of business, thereby exposing each firm to similar business risks. Additionally, all the major US investment banks exploited the temporary benefits of the 'leverage effect' which placed undue strain on their balance sheet structures and liquidity positions, thereby contributing to

their financial distress and as a combined group added to systemic risk within the financial markets.

A common theme found in this thesis was that regulators were subject to a 'regulatory capture' by the investment banking industry. Prior to the GFC, DiMaggio & Powell's (1983) coercive pressure was exerted by the industry directly and indirectly through political contributions, the lobbying process and exploitation of knowledge asymmetry in order to influence the regulatory process. The ultimate purpose of the industry's significant expenditure of resources to these processes was to engineer a regulatory environment conducive to optimising financial success. The research also reveals the limitation of regulations to control behaviour. The major restrictions on investment banks constituted: the capital regulations, which were found to be lenient and were effectively subject to voluntary compliance; NYSE's corporate governance rules and guidelines; and, SOX, all of which failed to prevent the failure of the largest US investment banks. Influence either through the exercise of power or institutional pressure is an immeasurable phenomenon and therefore is difficult to control.

The role played by the CRAs in publishing excessively positive and later found to be, flawed credit ratings on issuers was one of the many factors which contributed to the GFC. The key finding is that it was in the best interests of the investment banking industry to exert its influence coercively over the CRAs. This influence was exerted through their commercial support and providing persuasive feedback to CRAs on the complex ratings models employed as many of the rated issuers were either customers or securitisation vehicles sponsored by investment banks themselves. Ultimately the investment banks were able to achieve their desired outcomes of influencing the production of over-inflated ratings for their customers and more importantly their own securitisations of MBS and CDOs. As a result they were able to achieve superior securities prices and timely issues to ensure the highest possible throughput of transactions. Further, if an investment bank is routinely perceived as achieving a higher rating for its client than was expected, this skill would enhance its reputation in the market and therefore potentially attract a greater number of clients seeking to minimise their cost of capital.

Institutional pressure was also applied in the form of regulatory requirements for credit ratings. There was a natural and skewed demand for higher rated issues - at least equal to or higher than the minimum 'investment grade' band of 'BBB' which is the lowest rating for many of the relevant regulations governing an investable universe⁹⁶ for certain government and semi-government authorities. Further, for an underwritten securities issue to be successfully placed, the underwriting investment bank's job is made easier if the credit rating of its issuer meets the minimum investment grade level. This scenario provided a potential arena for investment banks to exert coercive pressure on the CRAs to rate an issue such that it met the minimum threshold. The CRAs' business model which employed an issuer pays system within a competitive environment influenced CRAs to placate the investment banks so as to sustain an increasing volume of ratings and thereby support their own survival.

Three findings relating to the influence on accounting standard setters are revealed in this thesis. Firstly, a normative influence was exerted on the FASB by industry in general; secondly the FASB was subject to subtle coercive pressure; and, thirdly a reverse legitimisation was sought by the FASB. All three forms of influence combined, resulted in the production of an accounting standard which favoured investment banks by potentially allowing them to conceal debts in their financial statements. The example used in the thesis was the process used to establish FAS 140, and its predecessor FAS 125 relating to the accounting of repurchase agreements. The process involved a consultation phase through which the investment banking industry's influence was applied, principally through their comment letters. The resultant accounting standard allowed flexibility to account for these instruments as either sales or on balance sheet liabilities. By choosing the former treatment, investment banks could remove potential liabilities from their balance sheets and disguise their actual financial position from stakeholders. This practice was employed by LB which resulted in excess of USD 50 billion of debt omitted from its balance sheet and an understating of its leverage ratio.

The normative influence stemmed from a mutual reliance between the standard setter and the industry participants which incubates a culture of similarity and supports the contention of a common world view within a profession. This common view construes professionalism

⁹⁶ An investable universe consists of all available investments that can be made within the sector specified.

by members collectively and defines the appropriate ways in which to behave and act. FASB's treatment of the submission letters was aligned to the persuasive arguments of the industry. Since the standard setters and the practitioners are members of the same professional community, they are able to collectively determine a set of practices and cognitive frameworks in which organisational routines are shaped. This type of normative pressure is heightened particularly if a large volume of submissions are conveying the same recommendation.

The second concept of a subtle coercive pressure is demonstrated through the enthusiasm of the financial institutions to appear in front of the FASB during direct hearings over the exposure draft to FAS125, the predecessor to accounting standard FAS140 and which carried the key contentious clauses, to declare their views and recommendations. According to Financial Accounting Standards Board (1996b), there were 60 respondents who spoke at public hearings in 1996. As discussed in section 3.1.3, coercive pressures may take various forms and be disguised or restrained. Although it "may be felt as force or persuasion, and are generally associated with explicit and direct impositions, coercive pressures may also be more subtle" (Devin & Bartlett 2011, p. 5). The subtle coercive pressure over the FASB to follow the wishes of the financial markets industry in their opposition to the 90-day Bright-line test can be interpreted as political influence. The influence was derived from the overwhelming number of participants who in addition to forwarding documentary submissions, contributed in the direct hearings that followed.

The third concept which allows the conveyance of influence is that of reverse legitimisation. As discussed in section 3.1.3, Riaz (2009) contends that if organisations such as investment banks are successful, the institutions such as the FASB from which organisations and practitioners sought legitimacy, are endorsed as the responsible entities which supported those successful organisations and practitioners under their authority.

For reverse legitimisation to exist, industry participants would be expected to support the FASB as long as its standards are valuable to those participants. This is consistent with the concept that the involvement of industry participants in the consultation process through the writing of comment letters is a vital measure of the legitimacy of the standard setting process and in turn the supervisors of this process – the FASB (Durocher et al. 2007; Fogarty 1992; Larson 2002; Olusegun Wallace 1990). The following section presents findings related to the exertion of power. The section focuses on the noxious exercise of power by LB's CEO resulting which contributed to the development of a dysfunctional culture characterised by incompetent decision-making ultimately leading to the failure of the firm.

11.2.3 Exertion of Power

This thesis finds that LB's organisational culture was influenced by its CEO and Chairman Richard Fuld. Firm culture is an important consideration for firm survival, as a dysfunctional

culture could lead to suboptimal management decisions, potentially leading to financial distress. As shown by CHAPTER 4 and CHAPTER 5, firm culture is influenced by a firm's history. Fuld persisted with the firm's long standing historical objectives of growing the firm. However Fuld's strategy tended to push the risk boundaries even further than his predecessors in the areas of leverage, product innovation and most significantly asset positions such as an ill-informed overexposure to the property market during the formation of a housing bubble. This objective of attempting to generate ever increasing profits was also self-serving as a large portion of Fuld's compensation consisted of bonuses aligned with firm performance. The thesis finds that Fuld's management style in attempting to achieve his personal goals such as maximising personal compensation, reputation and position longevity involved the exertion of power. Fuld's power, which flowed from Clegg's (1989) episodic, dispositional and facilitative circuits, was exerted over the firm's corporate governance system and his employees and their families.

Fuld's influence over the firm's corporate governance involved his decision to influence the appointment of board members who mostly lacked the background and experience to carry out their responsibilities effectively in a complex financial institution. Additionally Fuld constructed an attractive board compensation structure which enticed board members to remain on the board and perpetuate their longstanding relationships with the Chairman and senior management and a committee meeting schedule favouring compensation over finance and risk matters. This combination of board characteristics and processes led to a less than optimal monitoring performance and level of engagement from the Board.

Another insight to Fuld's use of power is reflected in his relationship with employees, where power was routinely exercised to ensure the pursuit of his strategy of generating 'growth at all costs'. The first step in his journey for control as CEO was achieved by appointing like-minded, compliant staff who shared his values to crucial positions. These appointments almost exclusively originated from the trading side of the business, an area in which Fuld devoted much of his career and where he understood the trader mentality typified by a penchant for risky transactions. Moreover these appointments created an inner circle with whom Fuld could feel comfortable and avert conflict.

The resultant corporate culture can be examined in certain communications between senior executives of the firm. Internal communications showed Fuld routinely resisted advice from other senior executives, most importantly the Chief Risk Officer relating to the firm's excessive business risks. His disregard of consistent warnings is an example of Fuld's misplaced self-assuredness of possessing superior knowledge regarding the market environment. These qualities are also exemplified by his management style which was tainted by arrogant and overconfident behaviour especially during the firm's financial crisis at the time of seeking a white knight'. As employees observed Fuld's self-perceived superiority, a CEO with a long history in the financial markets, and a leader willing to reward well performing loyal

employees, they succumbed to his growth agenda. This power which is often exercised intermittently, involves power over another, in this case Fuld's power over LB's employees. Interestingly the thesis finds that the firm culture influenced by Fuld's power, resulted in an organisation's value set at odds with the firm's documented code of ethics. Fuld's initial denial of his own accountability to the firm's difficulties reflects his mantra of 'surviving at all costs' and is shown in itself, as an exercise of power. As the firm's performance deteriorated, Fuld's credibility and power diminished, shifting towards creditors and regulators, who had an increasing say in the firm's future. Ultimately, the shift in power was too great and they decided to allow LB to fail. The following section sets out the contribution of the research and finds relevance to modern day dilemmas faced by the industry, policy makers as well as to the regulatory framework.

11.3 Contribution and Relevance of Research

11.3.1 Contribution

This thesis is motivated by a desire to better understand the causes of the GFC by examining the largest corporate failure in US history up to that time. Rather than limiting the analysis to economic or technical factors, the thesis peels back the layers of the causes of LB's failure to reveal a story involving human and organisational interactions within a socially constructed environment. There is a relative dearth of qualitative research on the investment banking industry which this thesis addresses.

The primary contribution of this thesis is its use of two theoretical frameworks in explaining the downfall of LB and providing a rich insight into the investment banking industry and the role of the financial network in the lead up to the GFC. The application of the two theoretical frameworks is unique and was necessary as the use of a single theory would have been insufficient to explain both internal and external influences on LB's failure. The case study provided an analysis of practice within the industry and permitted an evaluation of the two theoretical frameworks used. This use of the two theories combined with an historical approach and case study method is unique in explaining the cause of LB's failure and offering insight into the GFC.

New Institutional Theory was valuable in elucidating the isomorphic influences on the financial network, for example from the mimicking of financial structures and models between investment banks, to the influences applied to accounting standard setters. However this theory is not sufficient to explain all the undercurrents at play in the major decision-making by members of the financial network. To help explain the behaviours and culture prevalent at the time, the Theory of Power was useful in identifying how the use of power was in-

strumental in guiding LB down a path of self-destruction. The effective use of power over others within the organisation was the principal tool used by its CEO for his self-interest purposes. In the process he was able to affect the culture in a way that imbued the firm with his own view of the world and to support his objective of growth and later, 'survival at all costs'. Ironically, the power that facilitated the realisation of Fuld's ambitions eventually backfired in line with the firm's diminishing fortunes. Instrumentally, shareholders, creditors and regulators, who were earlier subjected to Fuld's influence, had gained the ascendancy and ultimately triggered his downfall.

This study therefore constitutes an alternative means of understanding the GFC and failure of one of the largest investment banks in the US. The qualitative factors revealed by this research offer an understanding of the influences on the evolution of the regulatory field and the challenges and potential weaknesses confronting the investment banking industry, which in turn can enlighten the industry's *modus operandi*. The relevance to the current environment is topical as shown by the following section.

11.3.2 Relevance of Research

The investment banking industry has been linked to repeated financial crises. Although discussion on financial and economic factors contributing to financial crises have been well covered, this research is intended to inform governments and regulators to better frame and implement policies, legislation and regulations and warn investment banks of the pitfalls of a dysfunctional organisational culture in order to mitigate a repeat catastrophe of the GFC and failure of large non-bank financial institutions.

It is reassuring that since the GFC, the US government and regulators have implemented many improvements to the regulatory framework. Significant progress was made in strengthening financial market regulation with the enactment of the Dodd–Frank Wall Street Reform and Consumer Protection Act (*The Dodd–Frank Wall Street Reform and Consumer Protection Act* 2010). However at the time of writing this thesis, The US Government under the Trump Administration announced more than 100 changes to regulations intended to loosen restrictions on financial institutions, importantly including those applying to 'bad behaviour':

Changes proposed by the Treasury Department include easing up on restrictions big banks now face in their trading operations, lightening the annual stress tests they must undergo, and reducing the powers of the Consumer Financial Protection Bureau (CFPB), which has been aggressively pursuing bad behaviour by financial institutions (Schroeder & Lambert 2017).

This development runs contrary to the recommendations of this thesis and is of particular concern as the proposed changes apply mainly to those investment banks which survived the GFC, either as separate entities or divisions of larger banks.

The industry has long sought many of the proposed changes, which would mostly benefit banks like JPMorgan Chase & Co, Bank of America Corp, Citigroup Inc, Wells Fargo & Co, Goldman Sachs Group Inc and Morgan Stanley (Schroeder & Lambert 2017).

Therefore, it is hoped that the findings of this thesis are noted by policy makers and regulators. Carefully consideration should be given to pitching supervisory tools available such as capital adequacy, liquidity and other relevant prudential rules and guidelines at an appropriate level to manage the systemic and firm specific risk within the investment banking industry. Specifically, more attention, not less, should be applied on matters of organisational culture within investment banks and a system of disincentives for breaches of good corporate conduct should be implemented. Given the fast-paced economic and technological developments, combined with an industry that readily adopts innovation, these strictures need to be regularly monitored and amended if necessary. A narrowing of the knowledge asymmetry between investment bankers and regulators, whereby investment banking professionals are able to influence regulators through their more intimate knowledge of certain financial products and risks would assist in addressing the monitoring role by regulators. A regulatory review of compensation structures at all senior levels within the industry could assist in narrowing compensation inconsistencies between industry and government agency employees. This would in turn mitigate some of the general flow of highly talented individuals to industry instead of regulatory agencies. The above recommendations would contribute to the government's and regulators' responsibilities towards the public interest.

This thesis emphasised the importance of independence for accounting standard setters. Better systems of identifying otherwise unintended consequences from new or amended accounting standards is encouraged. On 12 June 2014, the FASB introduced Accounting Standards Update No. 2014-11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures (Financial Accounting Standards Board 2014). This standard removes any ambiguity relating to the accounting for repurchase agreements by eliminating the option to account for repurchase agreements as sales, and confirms that they should be accounted for as secured borrowings:

First, the amendments in this Update change the accounting for repurchase-to-maturity transactions to secured borrowing accounting. Second, for repurchase financing arrangements, the amendments require separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement (Financial Accounting Standards Board 2014).

Although addressing the problem, FASB's clarification for the accounting treatment of repurchase agreements has come six years following LB's bankruptcy and the acknowledgement of the firm's unethical application of FAS 140.

The other financial network participants found to be deficient in their responsibilities were the CRAs which also contributed to the GFC. It is encouraging that *The Dodd–Frank Wall Street Reform and Consumer Protection Act 2010*) addressed many shortcomings of the CRAs. However much still needs to be done. The regulations which require government sanctioned organisations to invest within prescribed rating bands have not been changed at the time of writing. Further the thesis found the CRAs issuer pays business model created conflicts of interest and despite considerable discussion between the SEC, the CRAs and industry, no changes have been made as yet. Considerable time has elapsed since the GFC and developments relating to the above proposed amendments to regulations have yet to be implemented, reflecting a lack of urgency from the regulatory sphere. The SEC annually reviews progress on the evolution of the regulatory framework relating to CRAs and in its latest report of findings in 2016 did not find any current deficiencies. In relation to its investigations, the SEC is keeping its process open, therefore confirming its lack of urgency, acknowledging that it “has not determined whether any finding discussed in this Report constitutes a material regulatory deficiency, but may do so in the future” (Securities and Exchange Commission 2016, p. 12).

Finally this thesis warns of the adverse consequences that a concentration and misuse of power poses to investment banks. Effective corporate governance assists in promoting responsible management decision-making. The board of directors represent the ultimate group responsible for corporate governance. Therefore their appointment should be independent from the influence of management they are responsible for overseeing. Moreover a meticulous process should be employed in ensuring the appointment of skilled, experienced and engaged directors. Corporate governance should include formal and informal ethical guidelines which imbue appropriate values within the firm as opposed to a mere tick a box approach. Values can also be influenced by compensation structures offered to employees, senior management and the CEO, thereby implying that a balance needs to be reached between encouraging strong performance on the one hand and encouraging responsible practice within a firm on the other. A degree of independence is also encouraged for those responsible for safeguarding the business risks of a firm at the operational level. This is usually the CRO who possesses a deep knowledge of a firm's risks and who should be insulated from undue influence from senior management. Ultimately it is recommended that CROs should have direct access to the board of directors during conflicts on risk positions.

11.4 Limitations and Recommendations for Future Research in the Area

The time period selected, which ends at the time of LB's bankruptcy in 2008, is limiting with respect to the regulatory, commercial, social and political responses post-GFC. Similarly this study is conducted using the US as its subject field and a detailed discussion of the effective failure of other international investment banks is beyond the scope of this study and is recommended for future research. Similar studies covering other jurisdictions would be informative on the impacts on the investment banking industry from diverse cultures and on whether investment bankers in these other countries exhibit similar characteristics and behaviours. This study also uses secondary data from third parties such as journalists, books authored by ex-employees who may have accounts of industry participants. The use of primary sources to delve into the cultural and behavioural traits found within the industry, such as personal interviews with surviving individuals directly involved in the story would provide a deeper insight.

Consistent with the views of Sinclair (2010), the importance of a transparent and distinct separation between investment banking industry participants and their regulators is relatively under researched and further study of the relationships between the regulator and the regulated is considered worthwhile. The evolution of regulation and a comparison with other jurisdictions can inform future attempts to improve the regulatory framework. Therefore a detailed study of the history of capital regulation is recommended for the US and other countries' investment banking industries. Of particular interest would be the disparity and disproportionality of regulations between the investment banking and banking industries. This disproportionality in addition to the decision to establish the Consolidated Supervising Entity program for the investment banking industry in 2004, which was found to be deficient, warrants further research.

In conclusion, the GFC represented a massive failure of institutional practice and the human condition. Quantitative analysis cannot account for the forces which impacted on the important decisions made by participants in the financial network. The choice of theoretical perspectives of Clegg's (1989) Theory of Power and DiMaggio & Powell's (1983) New Institutional Theory represent a way to understand these forces. If the human condition and institutional practices are unchangeable, then the world is destined to repeat the failures of the past and guarantee future financial crises. It is up to bodies mandated by the wider public to mitigate as best they can the repeat of the GFC in view of the many casualties, both corporate and public. This implies an appropriate legislative response and a reflection on our human frailties which cause us to disproportionately prioritise self-interest over the public good. Gordon Gekko, an infamous investment banking character in the movie 'Wall Street'

famously stated that 'greed is good'. The movie explored the question as to whether greed benefits the self-interested individual at the expense of corporate shareholders. Applying the same concept in the context of this thesis, the phrase could be restated as 'power and influence are good'. However this thesis has shown this to be a flawed belief in the investment banking industry given the costs to the public interest.

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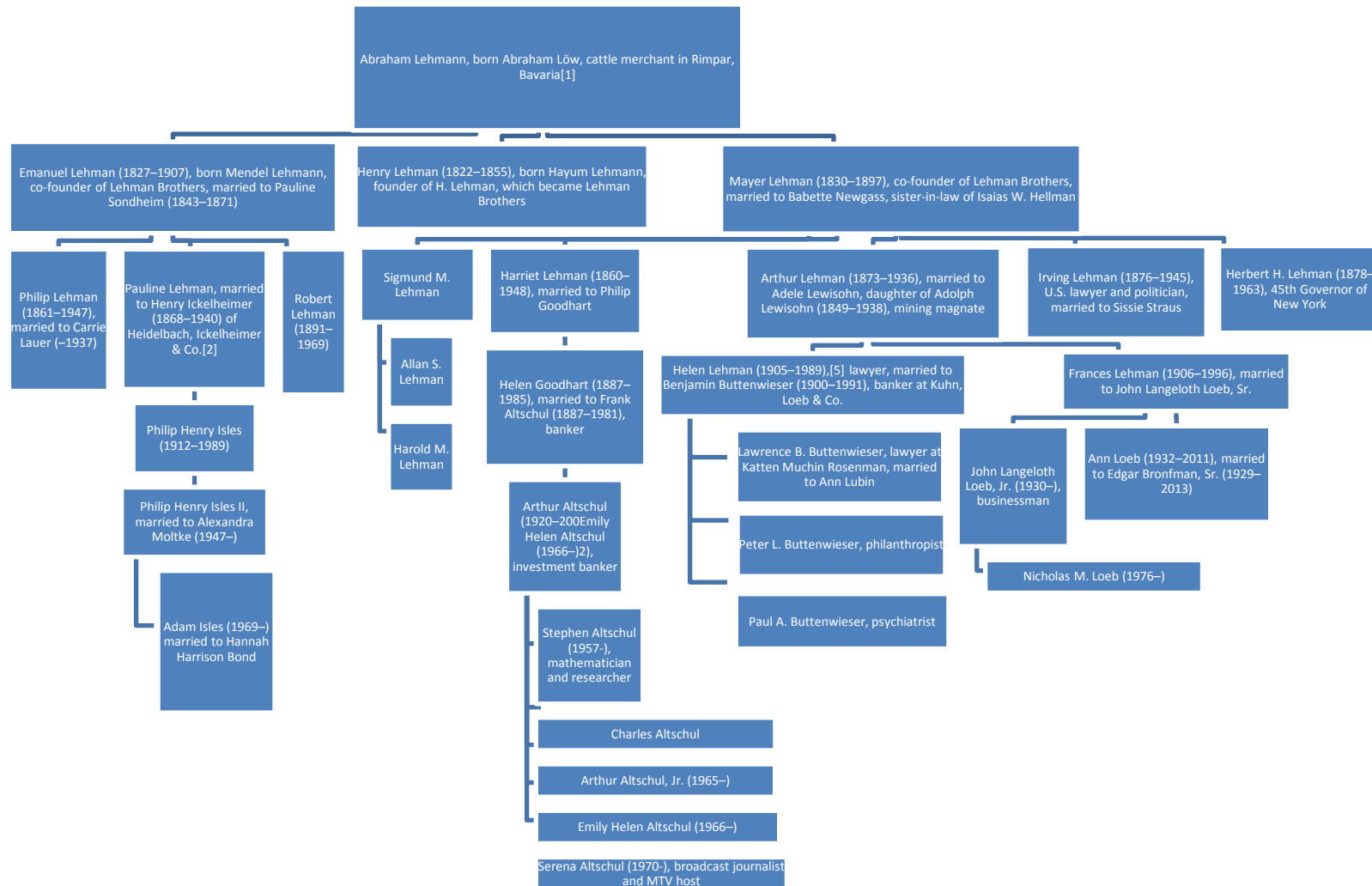
Appendix A - Deregulation Timeline for Investment Banking Industry

Year	Event / Act	Description
1978	Marquette vs. First of Omaha	Supreme Court allows banks to export the usury laws of their home state nationwide and sets off a competitive wave of deregulation, resulting in the complete elimination of usury rate ceilings in South Dakota and Delaware among others.
1980	Depository Institutions Deregulation and Monetary Control Act	Legislation increases deposit insurance from USD 40,000 to USD 100,000, authorizes new authority to thrift institutions, and calls for the complete phase-out of interest rate ceilings on deposit accounts.
1982	Garn-St. Germain Depository Institutions Act	Bill deregulates thrifts almost entirely, allowing commercial lending and providing for a new account to compete with money market mutual funds. This was a Reagan administration initiative that passed with strong bi-partisan support.
1987	Federal Savings and Loan Insurance Corporation (FSLIC) Insolvency	U.S. Government Accountability Office declares the deposit insurance fund of the savings and loan industry to be insolvent as a result of mounting institutional failures.
1989	Financial Institutions Reform and Recovery Act	Act abolishes the Federal Home Loan Bank Board and FSLIC, transferring them to OTS and the FDIC, respectively. The plan also creates the Resolution Trust Corporation to resolve failed thrifts.
1994	Riegle-Neal Interstate Banking and Branching Efficiency Act	This bill eliminated previous restrictions on interstate banking and branching. It passed with broad bipartisan support.
1996	Fed Reinterprets Glass-Steagall	Federal Reserve reinterprets the Glass-Steagall Act several times, eventually allowing bank holding companies to earn up to 25 percent of their revenues in investment banking.
1998	Citicorp-Travelers Merger	Citigroup, Inc. merges a commercial bank with an insurance company that owns an investment bank to form the world's largest financial services company.

Year	Event / Act	Description
1999	Gramm-Leach-Bliley Act	With support from Fed Chairman Greenspan, Treasury Secretary Rubin and his successor Lawrence Summers, the bill repeals the Glass-Steagall Act completely.
2000	Commodity Futures Modernization Act	Passed with support from the Clinton Administration, including Treasury Secretary Lawrence Summers, and bi-partisan support in Congress. The bill prevented the Commodity Futures Trading Commission from regulating most over-the-counter derivative contracts, including credit default swaps.
2004	Voluntary Regulation	The SEC proposes a system of voluntary regulation under the Consolidated Supervised Entities program, allowing investment banks to hold less capital in reserve and increase leverage.
2007	Subprime Mortgage Crisis	Defaults on subprime loans send shockwaves throughout the secondary mortgage market and the entire financial system.
2007	Term Auction Facility	Special liquidity facility of the Federal Reserve lends to depository institutions. Unlike lending through the discount window, there is no public disclosure on loans made through this facility.
2008	Bear Stearns Collapse	The investment bank is sold to JP Morgan Chase with assistance from the Federal Reserve.
2008	Primary Dealer Facilities	Special lending facilities open the discount window to investment banks, accepting a broad range of asset-backed securities as collateral.
2008	Housing and Economic Recovery Act	Provides guarantees on new mortgages to subprime borrowers and authorizes a new federal agency, the Federal Housing Finance Agency, which eventually places Fannie Mae and Freddie Mac into conservatorship.
2008	LB Collapse	Investment bank files for Chapter 11 Bankruptcy.

Source: (Sherman 2009) pp.1-2.

Appendix B - Lehman Family Tree



Appendix C - List of Transactions undertaken by LB 1971 – 1986

Year and Transaction
1973
1. Alison Mortgage Investment Trust (1 deal during the year)
2. Automatic Data Processing, Inc. (4 deals during the year)
3. Avis, Inc. (2 deals during the year)
4. C.I.T. Financial Corp. (10 deals during the year)
5. Chase Manhattan Mortgage and Realty Trust (3 deals during the year)
6. City of Clinton, IA / Standard Brands, Inc. (1 deal during the year)
7. Connecticut Light and Power Co. (1 deal during the year)
8. County of Ashland, Ohio (1 deal during the year)
9. Digital Equipment Corporation (9 deals during the year)
10. European Investment Bank (4 deals during the year)
11. Federative Republic of Brazil (1 deal during the year)
12. FibreBoard Corporation (3 deals during the year)
13. Gardinier, Inc. (1 deal during the year)
14. Marriott Corporation (2 deals during the year)
15. Massey-Ferguson Credit Corporation (1 deal during the year)
16. Met-Mex Penoles, S.A. (2 deals during the year)
17. Parker Drilling Company (1 deal during the year)
18. Peabody Galion Corporation (1 deal during the year)
19. The Medical Clinic Board of the City of Birmingham-South (Alabama) (1 deal during the year)
20. The Mortgage Bank and Financial Administration Agency of the Kingdom of Denmark (1 deal during the year)
1974
1. Abbott Laboratories (1 deal during the year)
2. Amsterdam-Rotterdam Bank N.V. (1 deal during the year)
3. Bankers Trust New York Corp. (3 deals during the year)
4. Bendix Corp. (1 deal during the year)
5. C.I.T. Financial Corp. (10 deals during the year)
6. California Pollution Control Financing Authority (1 deal during the year)
7. Caterpillar Tractor Co. (2 deals during the year)
8. Caterpillar Tractor Co. (2 deals during the year)
9. Chase Manhattan Corp. (2 deals during the year)
10. Chemical New York Corp. (4 deals during the year)
11. Clark Equipment Co. (1 deal during the year)
12. Clark Equipment Credit Corp. (5 deals during the year)
13. Continental Can Co., Inc. (5 deals during the year)
14. County of Monroe, Michigan (2 deals during the year)
15. Crocker National Corporation (3 deals during the year)

Year and Transaction
16. Diamond Shamrock Corporation (4 deals during the year)
17. European Coal and Steel Community (7 deals during the year)
18. General American Transportation Corporation (9 deals during the year)
19. General American Transportation Corporation (9 deals during the year)
20. General Foods Corporation (3 deals during the year)
21. Hercules Incorporated (2 deals during the year)
22. Inland Steel Company (3 deals during the year)
23. J. Lyons & Company Limited (1 deal during the year)
24. Macy Credit Corp. (4 deals during the year)
25. National Rural Utilities Cooperative Finance Corporation (4 deals during the year)
26. Ocean Highway and Port Authority (1 deal during the year)
27. Orange and Rockland Utilities, Inc. (1 deal during the year)
28. Philip Morris Incorporated (3 deals during the year)
29. The Detroit Edison Company (13 deals during the year)
30. Thermo Electron Corporation (2 deals during the year)
31. W. W. Grainger, Inc. (3 deals during the year)
1975
1. Asian Development Bank (2 deals during the year)
2. Associated Dry Goods Credit Corp. (1 deal during the year)
3. Bankers Trust New York Corp. (3 deals during the year)
4. Bethlehem Steel Corp. (5 deals during the year)
5. C.I.T. Financial Corp. (10 deals during the year)
6. Clark Equipment Credit Corp. (5 deals during the year)
7. County of Monroe, Michigan (2 deals during the year)
8. Crocker National Corporation (3 deals during the year)
9. Crown Zellerbach Corp. (1 deal during the year)
10. Department of Community Affairs and Economic Development of the State of Delaware (1 deal during the year)
11. Diamond Shamrock Corporation (4 deals during the year)
12. Digital Equipment Corporation (9 deals during the year)
13. European Coal and Steel Community (7 deals during the year)
14. European Coal and Steel Community (7 deals during the year)
15. European Investment Bank (4 deals during the year)
16. Flexi-Van Corporation (1 deal during the year)
17. FMC Corporation (3 deals during the year)
18. FMC Finance Corporation (1 deal during the year)
19. General Signal Corporation (1 deal during the year)
20. Hercules Incorporated (2 deals during the year)
21. Industrial Development Board of the City of Copperhill, Tennessee / Cities Service Company (1 deal during the year)
22. Industrial Development Board of the Parish of Calcasieu, Inc. / Cities Service Company (1

Year and Transaction
deal during the year)
23. Inland Steel Company (3 deals during the year)
24. International Minerals & Chemical Corporation (1 deal during the year)
25. International Telephone and Telegraph Corporation (9 deals during the year)
26. International Telephone and Telegraph Corporation (9 deals during the year)
27. ITT Financial Corporation (4 deals during the year)
28. Kerr Glass Manufacturing Corporation (1 deal during the year)
29. Kingdom of Norway (3 deals during the year)
30. Kingdom of Norway (3 deals during the year)
31. Koch Industries, Inc. (1 deal during the year)
32. Macy Credit Corp. (4 deals during the year)
33. Marriott Overseas Corporation N.V. (1 deal during the year)
34. Massey-Ferguson Nederland N.V. (2 deals during the year)
35. Minnesota Mining and Manufacturing Company (1 deal during the year)
36. Montgomery Ward Credit Corporation (3 deals during the year)
37. Montgomery Ward Credit Corporation (3 deals during the year)
38. Morrison-Knudsen Company, Inc. (1 deal during the year)
39. N L Industries, Inc. (1 deal during the year)
40. National Rural Utilities Cooperative Finance Corporation (4 deals during the year)
41. National Rural Utilities Cooperative Finance Corporation (4 deals during the year)
42. New York State Electric & Gas Corporation (4 deals during the year)
43. Pennzoil Company (2 deals during the year)
44. Philip Morris Incorporated (3 deals during the year)
45. Revlon, Inc. (6 deals during the year)
46. Revlon, Inc. (6 deals during the year)
47. Sybron Corporation (2 deals during the year)
48. Tektronix, Inc. (3 deals during the year)
49. Tektronix, Inc. (3 deals during the year)
50. Textron Inc. (1 deal during the year)
51. The Detroit Edison Company (13 deals during the year)
52. The Miller-Wohl Company, Inc. (1 deal during the year)
53. The Signal Companies, Inc. (1 deal during the year)
54. The Williams Companies (2 deals during the year)
55. USLIFE Corporation (1 deal during the year)
56. W. W. Grainger, Inc. (3 deals during the year)
57. Zapata Off-Shore Company (1 deal during the year)
1976
1. AMFAC, Inc. (1 deal during the year)
2. Eveleth Expansion Company (1 deal during the year)
1977

Year and Transaction
1. Chemical New York Corp. (4 deals during the year)
2. Fuqua Industries, Inc. (1 deal during the year)
3. General American Transportation Corporation (9 deals during the year)
4. ITT Financial Corporation (4 deals during the year)
5. Lehman Brothers (2 deals during the year)
1978
1. American General Insurance Company (1 deal during the year)
2. General American Transportation Corporation (9 deals)
3. GenRad, Inc. (5 deals during the year)
4. ITT Financial Corporation (4 deals during the year)
5. Memorex Corporation (1 deal during the year)
1979
1. Beckman Instruments, Inc. (4 deals during the year)
2. European Coal and Steel Community (7 deals during the year)
3. ITT Financial Corporation (4 deals during the year)
1980
1. GenRad, Inc. (5 deals during the year)
2. Geosource Inc. (1 deal during the year)
3. Tektronix, Inc. (3 deals during the year)
1981
1. The LTV Corporation (2 deals during the year)
1982
1. GenRad, Inc. (5 deals during the year)
1983
1. BGS Systems, Inc. (1 deal during the year)
2. GenRad, Inc. (5 deals during the year)

Source: (Baker Library Harvard University 2016)

Appendix D - Fed Funds Rate Changes

Year	Month	Fed Funds Rate	Comments
Federal Reserve Board Chairman - Alan Greenspan (August 1987 - January 2006)			
1987			1987: GDP = 3.5%, Unemployment = 5.7%, Inflation = 4.4%
	Sep	7.25%	
	Nov	6.75%	
1988			1988: GDP = 4.2%, Unemployment = 5.3%, Inflation = 4.4%
	Feb	6.50%	
	Dec	9.75%	
1989			1989: GDP = 3.7%, Unemployment = 5.4%, Inflation = 4.6%
	Dec	8.25%	H.W. Bush took office. Fed lowered rates.
1990			1990: GDP = 1.9%, Unemployment = 6.3%, Inflation = 6.1%
	Dec	7.00%	
1991			1991: GDP = -0.1%, Unemployment = 7.3%, Inflation = 3.1%
	Dec	4.00%	
1992			1992: GDP = 3.6%, Unemployment = 7.4%, Inflation = 2.9%
	Apr	3.75%	
	Jul	3.25%	
	Sep	3.00%	
1993			Clinton took office in 1993. Fed made no changes.
1994			1994: GDP = 4.0%, Unemployment = 5.5%, Inflation = 2.7%
	Feb	3.25%	
	Mar	3.50%	
	Apr	3.75%	
	May	4.25%	
	Aug	4.75%	
	Nov	5.50%	
1995			1995: GDP = 2.7%, Unemployment = 5.6%, Inflation = 2.5%
	Feb	6.00%	
	Jul	5.75%	

Year	Month	Fed Funds Rate	Comments
	Dec	5.50%	
1996			1996: GDP = 3.8%, Unemployment = 5.4%, Inflation = 3.3%
	Jan	5.25%	
1997			1997: GDP = 4.5%, Unemployment = 4.7%, Inflation = 1.7%
	Mar	5.50%	
1998			1998: GDP = 4.5%, Unemployment = 6%, Inflation = 1.6%
	Sep	5.25%	
	Oct	5.00%	
	Nov	4.75%	
1999			1999: GDP = 4.7%, Unemployment = 6%, Inflation = 2.7%
	Jun	5.00%	
	Aug	5.25%	
	Nov	5.50%	
2000			2000: GDP = 4.1%, Unemployment = 6%, Inflation = 3.4%
	Feb	5.75%	
	Mar	6.00%	
	May	6.50%	
2001			2001: GDP = 1.0%, Unemployment = 6%, Inflation = 1.6%. George W. Bush took office.
	Jan	6.00%	Jan-03
	Jan	5.50%	Jan-31
	Mar	5.00%	
	Apr	4.50%	
	May	4.00%	
	Jun	3.75%	
	Aug	3.50%	
	Sep	3.00%	
	Oct	2.50%	
	Nov	2.00%	
	Dec	1.75%	
2002			2002: GDP = 1.8%, Unemployment = 6%, Inflation = 2.4%
	Nov	1.25%	
2003			2003: GDP = 2.8%, Unemployment = 6%, Inflation = 1.9%
	Jun	1.00%	
2004			2004: GDP = 3.8%, Unemployment = 6%, Inflation = 3.3%

Year	Month	Fed Funds Rate	Comments
	Jun	1.25%	
	Aug	1.50%	
	Sep	1.75%	
	Nov	2.00%	
	Dec	2.25%	
2005			2005: GDP = 3.3%, Unemployment = 6%, Inflation = 3.4%
	Feb	2.50%	
	Mar	2.75%	
	May	3.00%	
	Jun	3.25%	
	Aug	3.50%	
	Sep	3.75%	
	Nov	4.00%	
	Dec	4.25%	
Federal Reserve Board Chairman - Ben Bernanke (February 2006 - January 2014)			
2006			2006: GDP = 2.7%, Unemployment = 6%, Inflation = 2.5%.
	Jan	4.50%	
	Mar	4.75%	
	May	5.00%	
	Jun	5.25%	
2007			2007: GDP = 1.8%, Unemployment = 6%, Inflation = 4.1%
	Sep	4.75%	
	Oct	4.50%	
	Dec	4.25%	
2008			2008: GDP = -0.3%, Unemployment = 6%, Inflation = 0.1%
	Jan	3.50%	Jan-22
	Jan	3.00%	Jan-30
	Mar	2.25%	
	Apr	2.00%	
	Oct	1.50%	
	Oct	1.00%	
	Dec	0%	

Source: Federal Reserve Bank of St Louis, Washington DC Effective Federal Funds Rate Database.

Appendix E - Main Types of Structured Finance Instruments

Asset-Backed Securities (ABS).

ABS is the general term for bonds or notes backed by pools of assets rather than a single corporation or government. Common types of collateral for ABS are auto loan receivables, and student loan receivables.

Mortgage-Backed Securities (MBS).

MBS are ABS whose cash flows are backed by the principal and interest payments of a set of mortgage loans. MBS can be divided into RMBS and commercial-mortgage-backed securities (CMBS), depending on the type of property underlying the mortgages.

Home Equity Loan Securities (HELS).

HELS are RMBS whose cash flows are backed by a pool of HELs.

Collateralised Debt Obligations (CDOs).

CDOs are structured finance securities that are pooled and tranching. CDOs are backed by a pool of assets, like other structured finance securities, but they issue classes of securities with some investors having priority over others.

Collateralised Bond Obligations (CBOs).

CBOs are CDOs backed primarily by high yield corporate bonds.

Collateralised Loan Obligations (CLOs).

CLOs are CDOs backed primarily by leveraged high-yield bank loans.

Collateralised Mortgage Obligations (CMOs).

CMOs are CDOs backed by mortgage collateral (often RMBS or CMBS rather than individual mortgages).

Appendix F - Political Contributions by the Investment Banking Industry in 2007

Contributor	USD Donated Over USD 500,000
Securities Industry & Financial Mkt Assn	5,680,000
Investment Co Institute	5,630,841
Blackstone Group	4,746,250
Merrill Lynch	4,420,000
Cerberus Capital Management	3,000,000
KKR & Co	2,820,000
Goldman Sachs	2,720,000
Private Equity Council	2,460,000
FMR Corp	2,395,000
Morgan Stanley	2,360,000
Credit Suisse Group	1,920,000
Managed Funds Assn	1,900,000
Principal Financial Group	1,883,047
CME Group	1,695,000
Charles Schwab Corp	1,652,000
TIAA-CREF	1,490,000
National Venture Capital Assn	1,445,739
NYSE Euronext	1,220,000
Federated Investors Inc	1,180,000
NASDAQ OMX Group	1,139,754
TPG Capital	920,000
Intellectual Ventures LLC	902,000
International Swaps & Derivatives Assn	900,000
JPMorgan Chase & Co	900,000
Trafigura Ltd	900,000
State Street Corp	880,340
Ameriprise Financial	848,677
Vanguard Group	800,000
Citadel Investment Group	790,000
Chicago Board Options Exchange	770,000
Bain Capital	720,000
Lehman Brothers	720,000
UBS AG	720,000
Financial Industry Regulatory Authority	680,000
American International Group	680,000
Alliance for Investment Transparency	680,000
Carlyle Group	680,000
Deutsche Bank AG	650,000
Options Clearing Corp	638,441
IntercontinentalExchange Inc	580,000

Contributor	USD Donated Over USD 500,000
Group MENATEP	560,000
Stanford Financial Group	540,000
E*TRADE Group	520,000
Oaktree Capital Management	510,000

Source: Centre for Responsible Politics (2008)

Appendix G - Regulatory Uses of Credit Ratings in the US

Year	Ratings Dependent Regulation	Minimum Rating	Regulator/ Regulation	Reason for Regulation
1931	Required banks to mark-to-market lower rated bonds	BBB	OCC and Federal Reserve Examination Rules	Prudence
1936	Prohibited banks from purchasing 'speculative securities'	BBB	OCC, FDIC and Federal Reserve joint statements	Prudence
1951	Imposed higher capital requirement on insurers' lower rated bonds	Various	NAIC mandatory reserve requirement	Capital Adequacy Requirement
1975	Imposed higher capital haircuts on broker dealers' below investment grade bonds	BBB	SEC amendment to rule 15c3-1, the uniform net capital rule	Capital Adequacy Requirement
1982	Eased disclosure requirements for investment grade bonds	BBB	SEC adoption of integrated disclosure system	Easier Market Access
1984	Eased issuance of non-agency mortgage backed securities	AA	Congressional promulgation of the secondary Mortgage Market Enhancement Act of 1984	Easier Market Access
1987	Permitted margin lending against MBS and (later) foreign bonds	AA	Federal Reserve regulation T	Prudence
1989	Allowed pension funds to invest in high rated ABS	A	Department of Labour relaxation of ERISA restriction	Investor Protection
1989	Prohibited S&Ls from investing in below investment grade bonds	BBB	Congressional promulgation of the Financial Institutions Recovery and Reform Act of 1989	Investor Protection
1991	Required money market mutual funds to limit holding of low rated paper	A1*	SEC amendment to rule 2a-7 under the investment company act of 1940	Investor Protection
1992	Exempted issues of certain ABS from registration as a	BBB	SEC adoption of Rule 3a-7 under the In-	Easier Market

Year	Ratings Dependent Regulation	Minimum Rating	Regulator/ Regulation	Reason for Regulation
	mutual fund		Investment Company Act of 1940	Access
1994	Imposes varying capital charges on banks and S&L's of different tranches of ABS	AAA and BBB	Federal Reserve, OCC, FDIC, OTS Proposed Rule on Recourse and Direct Substitutes	Capital Adequacy Requirement
1998	Department of Transportation can only extend credit assistance to projects with an investment grade rating	BBB	Transport Infrastructure Finance and Innovation Act 1998	Prudence
1999	Restricts the ability of national banks to establish financial subsidiaries	A	Gramm-Leach-Bliley Act of 1999	Prudence
2000	Loan by non-profit corporation eligible for guarantee under the Act provided that such corporation has one or more issues of outstanding long-term debt that is rated within the highest three rating categories of an NRSRO (District of Columbia – Appropriations Legislation)	A	Public Law 106-553	Prudence

Source: (Langohr & Langohr 2008) pp.432-433